NEW JERSEY'S MODEL RESPONSE TO PREDATORY LENDING: THE HOME OWNERSHIP SECURITY ACT OF 2002

By Baher Azmy and David Reiss

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INTRODUCTION

Home ownership in America comprises an elemental part of the metaphorical American dream, conferring social status, financial security and stronger community ties to its beneficiaries.[1] These benefits have been extended to a growing proportion of Americans in recent years, including minority and lower-income persons who have traditionally been excluded from access to the credit opportunities necessary to either purchase homes or collateralize their home equity into valuable liquid assets.[2] Over the past decade, a wave of new mortgage products – including loans to "subprime" borrowers – and a host of new providers – including mortgage brokers, mortgage bankers and finance companies – has simultaneously emerged to service this growing market sector.[3]

Some of those new providers, however, have become known for their unscrupulous business practices. Known as "predatory lenders," they prey on vulnerable and financially unsophisticated persons, trapping thousands into exploitative loans that are as equally profitable for lenders as they are destructive for borrowers.[4] Each year, predatory lending has sucked many billions of dollars out of the home equity and from the income of many Americans,[5] and has resulted in a rash of devastating residential home foreclosures throughout the nation. Notably, predatory lending has also been found in high concentrations in New Jersey.[6]

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1 *See* KENNETH JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES (1987).

2 According to a recent study by the U.S. Department of Housing and Urban Development, 40 percent of new homeowners since 1994 are minorities, even though they account for just 24 percent of the U.S. population and that African American and Hispanic homeownership rates have been growing at twice that of white homeowners. Department of Housing and Urban Development, Office of Policy Development and Research, *Issue Brief No.* 3 (December 2000); s*ee also* JOINT CENTER FOR HOUSING STUDIES OF HARVARD UNIVERSITY, THE STATE OF THE NATION'S HOUSING 15 (June 16, 2003), *available at* http://www.jchs.harvard.edu/.

3 *See* text accompanying *infra* notes __ to __.

4 *See* text accompanying *infra* notes __ to __.

5 ERIC STEIN ET AL., QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 2 (2001) (revised October 30, 2001) [hereinafter COST OF PREDATORY LENDING] (estimating that several categories of abusive lending practices cost American homeowners $9.1 billion annually).

6 *See* text accompanying *infra* notes __ to __.

Federal mortgage regulations and state law fraud protections have not sufficiently deterred predatory home lending practices in New Jersey. Indeed, even defining a core concept of "predatory lending" has eluded regulators[7] and scholars[8] because like, for example, the doctrine of unconscionability, its manifestations are generally context-specific.[9]

New Jersey, by passing the Home Ownership Security Act in 2002 ("HOSA" or "the Act"),[10] became one of a handful of leading states to comprehensively respond to the problem of predatory lending within its borders. [11] The New Jersey legislature did not choose to specifically define "predatory lending" nor to simply leave a definition of the prohibited practice sufficiently broad and ambiguous so that common law courts could adjudicate its parameters on a case-by case basis. Rather, following the lead of other states and a framework set up by the federal Home Ownership Equity Protection Act,[12] New Jersey designated certain practices abusive where they have little or no market justification when made in connection with already expensive residential

[7] *See* Senate Committee on Banking, Housing and Urban Affairs, *Predatory Lending Practices: Staff Analysis of Regulators' Responses* (August 23, 2000) (recommending that no additional regulations of "predatory lending" should be undertaken because no adequate definition exists to describe the practice); *See also* Departments of the Treasury and Housing and Urban Development, *Curbing Predatory Home Mortgage Lending* 27 (June 20, 2000) [hereinafter Joint HUD-Treasury Report] (declining to establish specific definition of "predatory lending" but identifying core predatory lending practices that should be subject to regulation), *available at*: http://www.hud.gov/library/bookshelf18/pressrel/tresrpt.pdf.

[8] See, e.g. Kurt Eggert, *Held Up in Due Course, Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 511-13 (2002) (surveying variety of definitions proposed by scholars and regulators). Professors Cathy C. Engel and Patricia A. McCoy also demur from offering a precise definition of predatory lending, choosing instead to classify certain lending practices as unfair through framework of law economics. Kathleen C. Engel and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002). They suggest that predatory behavior includes loans that: (i) are structured to result in seriously disproportionate net harm to borrowers; (ii) engage in rent seeking; (iii) involve fraud or deceptive practices; (iv) lack transparency; (v) require borrowers to waive meaningful legal redress. *Id.* at 1260.

[9] Relying in part on a definition adopted by the New Jersey Appellate Division, *Associates Home Equity Serv., Inc. v. Troup*, 343 N.J. Super. 254, 267-8 (App. Div. 2001), the authors would define predatory lending as a set of practices, engaged in by lenders, mortgage brokers and home improvement contractors, usually through aggressive or deceptive sales tactics, that are so disadvantageous or abusive that the borrower is subjected to an unreasonable risk of default and foreclosure.

[10] 2003 N.J. SESS. LAW SERV. CH. 64 (West), codified at N.J. STAT. ANN. 46:10B-22 (West 2003)

[11] *See* 2003 ARK. ACTS §2598 (2003); CAL. FIN. CODE § 4970-4979.7 (2003); Fair Lending Act, GA. CODE. ANN. §7-6A-1-13; High Risk Home Loan Act, 2003 ILL. LAWS S.B. §1784; High Cost Mortgage Loan Provisions, MASS REGS. CODE TIT. 209 § 32-32 (2003); 2003 N.M. LAWS CH. 436; 2001 N.Y. LAWS §11856; Restrictions and Limitations on on High Cost Home Loans, N.C. GEN. STAT. § 24-1.1e (2003); High Cost and Consumer Home Loans Act, 2003 S.C. ACTS § 438.

[12] 15 U.S.C. § 1639 (2002).

mortgage loans and where they cause an unreasonable risk of foreclosure.[13]

The New Jersey Home Ownership Security Act fills an important regulatory gap left open by current federal and state law. By attempting to proscribe certain unjustifiable practices in connection with high-cost, high-risk loans, the Act goes a long way toward accomplishing its goals of simultaneously protecting home ownership and keeping an ample supply of credit available at reasonable terms for all borrowers, including subprime borrowers.[14]

In this article, we will first describe the background of the emerging predatory lending problem by locating the practice in the broader subprime mortgage lending market; identifying the emergence of loan terms and practices the New Jersey legislature concluded were abusive; and documenting the prevalence and consequences of the predatory lending problem in New Jersey and particularly within its low income and minority communities. In Part II of the article, we will provide a detailed analysis of the Act's provisions, demonstrating specifically how it is designed to remedy the problem and highlighting some of its relative strengths and weaknesses. In Part III we will consider some questions left open by the Act, including whether the Act could be even more aggressive; whether it will hurt the broader subprime lending market and the low-income and minority borrowers who often depend on it; and whether its controversial provisions assigning liability for Act violations to secondary purchasers of mortgage notes will have a significant impact on the availability of loans for New Jersey residents.

I. THE EMERGENCE OF PREDATORY LENDING IN NEW JERSEY

A. Explosion Of The Subprime Lending Market

Predatory lending is a distinct and dangerous subset of the generally positive emergence of subprime lending in the residential mortgage market. A subprime loan is generally intended to extend credit to a borrower who, for reasons such as a poor credit record, high debt-to-income ratio, or unstable employment history, cannot qualify for a conventional or prime mortgage loan.[15] Because of the higher costs associated with subprime borrowers' ostensibly greater risk of default, delinquency and foreclosure, subprime loans carry higher interest rates than conventional loans.[16] Studies have estimated that subprime loans have on average a 2.5 to 4 percentage points higher interest rate than prime loans.[17] Subprime lenders also typically charge higher points and

[13] N.J. STAT. ANN. 46:10B-25-26.

[14] N.J. STAT. ANN. 46:10B-23(2)(b) and (c).

[15] *See* JOHN C. WEICHER, THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT 29 (1997).

[16] Joint HUD-Treasury Report at 27-28.

[17] *Id.* at 30. *See also* Cathy L. Mansfield, *The Road to Subprime 'HEL' Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime*

fees– charges assessed at the outset of the loan and paid either in cash or financed into the overall loan proceeds – to compensate for higher origination and servicing costs subprime loans are generally believed to carry.[18] Notwithstanding these increased costs, subprime lending is generally considered to be an extremely positive development, allowing those traditionally excluded from conventional mortgage borrowing to access credit for home purchases[19] or to access the equity in their homes for other uses.[20]

The subprime lending industry, once virtually nonexistent, has experienced tremendous growth in the past decade. In 1993, only $35 billion in nationwide loans were subprime, accounting for only 3% of overall mortgage loan originations; by 1998, subprime lending totaled $160 billion and its share of overall mortgage originations ballooned to 15%.[21] Subprime lending has continued its dramatic expansion, originating $200 billion in mortgages in 2002 across the country.[22] New Jersey has witnessed proportional growth. Between 1993 and 2000, the number of subprime loans increased in New Jersey from 2,693 to 25,403 and the percentage share of subprime lending in the overall New Jersey mortgage market increased from 1% to 14%.[23] The causes of this growth are complex and multifaceted. They include the substantial

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Home Equity Loan Market, 51 S.C. L. REV. 473, 533 (2000) (describing her study of cross section of subprime loans originated between 1996-1999 which averaged 2.2 to 4.06 higher interest rate than prime loans in a comparable period). Within the subprime market, there are grades assigned from A-, B, C, D to represent progressively higher credit risks and which are assigned correspondingly higher interest rates. *See* WEICHER, *supra* note __ at 17 (reporting that subprime loans between the period 1996-1999 were on average 3 percentage points higher than prime loans, but that large variations, between 2 to 6 percent existed among grades of subprime loans).

18 WEICHER, *supra* note __ at 67, 69 (describing higher origination costs and higher servicing costs associated with increased rates of delinquency and foreclosure). Delinquency and foreclosure rates are much closer, when A- subprime borrowers are compared to prime borrowers. *Id*. at 35. As discussed in detail below, however, it is remains unclear whether subprime loans accurately reflect an inherent market risk of default associated with their borrowers or whether overly-costly subprime rates and points and fees actually push borrowers unnecessarily over the brink of default or foreclosure. *See* text accompanying *infra* notes __ to __.

19 Ken Zimmerman, Director of New Jersey Institute for Social Justice, Speech at the Seton Hall Law School Predatory Lending Conference (June 17, 2003).

20 *See* Glenn B. Canner, et al. *Recent Developments in Home Equity Lending*, 84 FED. RES. BULL. 241 (April 1998) (describing some of the benefits of home equity lending to consumers), *available at* www.federalreserve.gov/pubs/bulletin/1998/199804lead.pdf.

21 HUD-Treasury Joint Report, *supra* note__ at 50.

22 Robert E. Litan, *Unintended Consequences: The Risks of Premature State Regulation of Predatory Lending*, *available at*: http://www.aba.com/NR/rdonlyres/00007106megriyjcceyllhml/PredReport20092.pdf.

23 KEN ZIMMERMAN, ET AL., PREDATORY LENDING IN NEW JERSEY: THE RISING THREAT TO LOW-INCOME HOMEOWNERS, New Jersey Institute for Social Justice at 5-6 (February 2002) [hereinafter PREDATORY LENDING IN NEW JERSEY], *available at* http://www.njisj.org/reports/predatory_lending.html.

increase in property values – and corresponding availability of leveraged home equity – across the economic spectrum;[24] tax incentives created by the 1986 Tax Reform Act which retained solely the mortgage interest rate as a category of tax-deductible consumer interest;[25] and the emergence of nontraditional, nondepository mortgage service providers such as mortgage brokers, mortgage bankers, finance companies and even home improvement contractors.[26]

Perhaps the most important catalyst for the growth of subprime lending, however, has been the correspondingly accelerating process of securitizing subprime mortgages and selling them on the secondary market.[27] This process has created a long funding pipeline connecting individual residential mortgage borrowers, loan originators (including mortgage brokers, home improvement contractors and an increasing variety of lending institutions), investment banks and investors of all kinds.[28]

On one end of the pipeline, a mortgage broker arranges financing for a borrower from any number of mortgage lenders, such as finance companies, mortgage bankers, banks, thrifts or credit unions.[29] Mortgage brokers typically charge points or fees for their services and thus make a commission off of the total loan amount at closing.[30] In addition, brokers frequently negotiate with lenders to be paid a "yield spread premium" which represents the difference between the rate the lender proffered the broker to extend to the borrower and the actual rate the broker extended to the borrower.[31] Home improvement contractors

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24 Margo Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 119 (2002).

25 Mansfield, *supra* note __ at 522.

26 HUD-Treasury Joint Report, *supra* note___ at 39.

27 *See* Eggert *supra* note __ at 534-52. The percentage of subprime mortgages that were securitized and sold on the secondary market increased from 32 percent in 1994 to 55 percent in 1998, before dropping to 37 percent in 1999. HUD-Treasury Joint Report, *supra* note__ at 40 and tbl. 3.4.

28 HUD-Treasury Joint Report, *supra* note__ at 35.

29 Mortgage brokers now account for almost fifty percent of all subprime mortgage originations. *The Problem, Impact and Responses: Hearing on Predatory Mortgage Lending Before Senate Comm. on Banking, Housing and Urban Affairs,* 106th Cong. (2001) (testimony of Neill Fendly, Immediate Past President of National Association of Mortgage Brokers). Brokers are heavily undercapitalized and, as a result rarely provide use their own funds to extend a loan. HUD-Treasury Joint Report, *supra* note __ at 40. Rather, they will typically close the loan in the lenders name, use "table funding" provided by a pre-designated purchaser of the loan, or access a line of credit from a finance company. Eggert, *supra* note __ at 538.

30 HUD-Treasury Joint Report, *supra* note___at 40.

31 HUD-Treasury Joint Report, *supra* note__ at 40. Yield spread premiums create strong incentives for brokers to steer borrowers to a higher rate and are particularly problematic when they are not properly disclosed to borrowers in advance of the loan closing. *See* Mansfield, *supra* note __ at 526.

often also originate mortgages for borrowers with pre-arranged lenders and are a significant source of abuse in the subprime lending process.[32]

A lender may hold a loan in its portfolio, collecting monthly mortgage payments as they come due and servicing the loan in all other respects. Most subprime lenders, however, securitize their loans. That is, lenders pool a large group of loans with similar risk grades together, securitize them and, through Wall Street investment banks, sell them to a vast secondary market of loan purchasers, which includes institutional investors, mutual funds and pension funds.[33] The enormous growth of securitization has had an utterly transforming effect on the mortgage services market. Securitization has simultaneously fueled the growth of subprime lending and the nontraditional, and comparatively underregulated, brokers and finance companies that dominate the market.[34] By selling their loans to the secondary market, subprime lenders do not need to wait for monthly mortgage payments to be made by borrowers. They thereby become free to finance new subprime loans.[35] With each financing, they collect points and fees, and with each sale to the secondary market, they collect an interest point spread.[36]

The secondary market seems highly enamored with subprime lending because the rates of return are enormously profitable given the overall risk profile of subprime borrowers.[37] As an added benefit to secondary market investors, and as described below, the secondary market can take advantage of the holder-in-due-courserule, [38] which generally immunizes them, as good faith purchasers, from liability for any fraud perpetrated by a loan originator.[39]

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[32] *See* text accompanying *infra* notes __ to __.

[33] HUD-Treasury Joint Report, *supra* note__ at 41.

[34] Eggert, *supra* note __ at 546.

[35] Engel and McCoy, *supra* note __ at 1274.

[36] Mansfield, *supra* note __ at 531.

[37] *See* Robert E. Litan, *Unintended Consequences: The Risks of Premature State Regulation of Predatory Lending*, *available at*: http://www.aba.com/NR/rdonlyres/00007106megriyjcceyllhml/PredReport20092.pdf; *Hearing Before the House Comm. on Banking and Financial Services*, 106th Cong. (2000) (testimony of Cathy Lesser Mansfield) [hereinafter Mansfield Testimony] (arguing that many subprime loans carry unjustified and "tremendously inflated costs"); see also Thomas Goetz, *Loan Sharks, Inc.*, Village Voice, July 15, 1997 at 33 ("subprime companies say their interest rates are so high to compensate for the greater risk these borrowers bring. But a welcome side effect of high rates is the profits that traditional banks can't hope to match. According to *Forbes*, subprime consumer finance companies can enjoy returns up to six times greater than those of the best-run banks. Corporate America hasn't failed to notice.")

[38] *See generally* U.C.C. § 3-302 and text accompanying *infra* notes __ to __.

[39] See *text* accompanying *infra* notes __ to __.

B. Predominance Of Subprime Lending In Minority Communities

Subprime lending is concentrated among low and moderate-income borrowers due in part to their typically lower income-to-asset ratios and shorter or weaker credit histories.[40] More highly troubling, however, is the remarkable predominance of subprime lending in African American neighborhoods. Nationwide, fifty percent of all loans in predominantly African American neighborhoods are subprime, compared to only nine percent in predominantly white neighborhoods.[41] Controlling for income, the disparity is even more stark: upper income African Americans are twice as likely as low income white borrowers to receive subprime credit.[42] In New Jersey, controlling for income and other key variables, African Americans are more than three times as likely as white borrowers to receive a subprime home equity loan; 2.5 times as likely as white borrowers to receive a subprime purchase money loan to buy a house; and, 1.4 times as likely as white borrowers to receive a subprime refinance loan.[43] These disturbing statistics demonstrate that much subprime lending is not accurately correlated to credit risk and corroborates the strong suspicion that much of subprime lending is predatory – that is, it charges far too high a price for the credit risk presented by an individual borrower.[44]

C. The Link Between The Subprime Market And Predatory Lending

As mentioned, the large majority of subprime loans are neither predatory or in need of regulation. However, certain lending practices, when done in connection with an already expensive subprime loan, are so abusive that they can properly be designated as predatory. One core feature that these practices have in common is their tendency to unfairly strip equity from a borrower. Typical predatory practices pad unnecessary charges in a loan and thereby decrease the value of the borrower's ownership interest in her home.[45] As a result, victims of predatory lending lose their primary – perhaps their only – source of wealth accumulation to the extent that they are unable to consistently make their loan payments or that actually causes them to lose their homes entirely.

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40 Department of Housing and Urban Development, *Unequal Burden: Income and Rational Disparities in Subprime America*, at 3 (April 12, 2000) [hereinafter *Unequal Burden*]. In low to moderate income neighborhoods, 26% of refinance loans were subprime, compared to a national average of 11% and an average of seven percent in upper income neighborhoods. *Id.* In New Jersey, sixty percent of lending in low-income areas is subprime. PREDATORY LENDING IN NEW JERSEY, *supra* note __ at 6.

41 *Unequal Burden*, *supra* note ___ at 3.

42 *Id.*

43 PREDATORY LENDING IN NEW JERSEY, *supra* note __ at 7.

44 *See* text accompanying *infra* notes __ to __. (next section)

45 COST OF PREDATORY LENDING, *supra* note __ at 4-5.

These practices, it should be noted, are rarely present in the conventional lending industry or in the legitimate subprime industry. Indeed, they are present only in the predatory subset of the subprime lending market – a subset that has captured a significant share of the subprime market and appears resistant to competition from the legitimate lending market for a variety of reasons. The most fundamental reason is that predatory lenders do prey on potential victims: they employ unique, aggressive and often highly misleading marketing and sales techniques. In order to identify potential victims, predatory lenders may search census records to look for predominantly African American tracts; deed records to identify persons that either own their homes outright or should have substantial equity in them; and tax records to identify delinquent persons who may be in need of money.[46] Predatory lenders and brokers then rely on direct marketing techniques – persistent calling or "live checks" – that are full of misleading enticements that have proven to be effective with the most vulnerable homeowners. These homeowners tend to be highly unsophisticated about mortgage products and largely disconnected from the financial services market.[47] As one self-confessed predatory lender described in testimony to the U.S. Senate, predatory lenders target "blue-collar workers, people who haven't gone to college, older people who are on fixed incomes, non-English-speaking people and people who have significant equity in their homes."[48] Moreover, once a predatory lender has secured a victim, his goal is to keep returning in order to repeatedly flip the victim's loan, churning additional fees and stripping additional equity each time.[49]

Legitimate subprime and conventional lenders do not, as a matter of course, engage in such aggressive marketing techniques. They tend to attract borrowers who both need credit and are sophisticated enough to shop around for their options.[50] However, once a borrower has been trapped in an equity-stripping loan, her loan-to-value ratio is likely too high to ever allow her to trade up to a legitimate subprime financing.

Some of the most common and most damaging equity-stripping or otherwise unreasonable lending practices are:

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46 ASSOCIATION OF COMMUNITY ORGANIZATIONS FOR REFORM NOW (ACORN), SEPARATE AND UNEQUAL: PREDATORY LENDING IN AMERICA 34-35 (November 2002) [hereinafter SEPARATE AND UNEQUAL].

47 *Id*; *see also* Eggert, *supra* note __ at 516.

48 *EquityPredators: Stripping, Flipping and Packing their Way to Profits: Hearing Before the Senate Special Committee on Aging*, 105th Cong. (1998) (testimony of "Jim Dough") [hereinafter Testimony of Jim Dough], *available at*: http://aging.senate.gov/events/hr14jd.htm. *see also id*. ("my perfect customer would be an uneducated widow who is on a fixed income, hopefully from her deceased husband's pension and social security – who has her house paid off, is living off of credit cards, but having a difficult time keeping up her payments, and who must make a car payment in addition to her credit card payments").

49 *See infra* note __.

50 Engel and McCoy *supra* note __ at 1289-90.

1. Lending Without Regard to Ability to Repay

Predatory lenders often will make a loan based upon the value of the equity the borrower has in the home but without concern for whether the borrower has enough income to support monthly mortgage payments. The practice is sometimes referred to as "asset-based lending."[51] This practice sets up a borrower for assured default and eventual loss of her home. Though foreclosure is typically costly and disfavored by legitimate mortgage lenders,[52] participants in the predatory lending pipeline may be unconcerned about the likelihood of foreclosure on these loans. Mortgage brokers will have received a commission at the outset from the loan proceeds (and have been known to exaggerate a borrower's credentials when presenting an application for lender approval); a lender can then immediately securitize and sell the loan to the secondary market and recover the value of the loan immediately; and the secondary market investor can still recoup losses because the asset-based lending is typically directed at borrowers who already have substantial equity in their homes.[53] As we shall see below, HOSA does not directly address this practice.[54]

2. Financing Points and Fees

Points and fees charged in connection with predatory loans routinely amount to between five and eight percent of the loan amount.[55] Points and fees can become even costlier because they are not paid in cash by the borrower but, rather, are financed as part of the total loan amount. As a result, a subprime borrower will pay the already high interest associated with her loan to finance the points and fees.[56] Financing points and fees can be dangerous because their costs are not transparent; such financing tends to obscure the true cost of the loan, particularly when many borrowers do not find out about the financing process until they are at closing.[57] Financing of points and fees can be

51 HUD-Treasury Joint Report, *supra* note __ at 76.

52 WEICHER, *supra* note __ at 84.

53 Eggert, *supra* note __ at 550-60.

54 *See* text accompanying *infra* notes __ to __.

55 COST OF PREDATORY LENDING, *supra* note __ at 6 (estimating that 750,000 loans annually have points and fees that are in excess of five percent of the total loan value); *see also* SEPARATE AND UNEQUAL, *supra* note __ at 37 (reporting that borrowers in predatory loans are "routinely" charged just under eight percent of the loan amount in points and fees), *available at* http://www.acorn.org/acorn10/predatorylending/plreports/report.htm. By contrast the average points and fees charged on conventional loans, if any are charged, is 1.1%.

56 Mansfield Testimony, *supra* note __ ("the combination of high points and fees in a refinance loan and high rates translate into exorbitantly higher costs for the borrower - much higher than they would be if the borrower were lent the second mortgage or unsecured credit product he/she sought in the first place").

57 COST OF PREDATORY LENDING, *supra* note __ at 4; Ken Zimmerman, Director of New Jersey Institute for Social Justice, Speech at the Seton Hall Law School Predatory Lending Conference (June 17, 2003).

particularly abusive when combined with other equity stripping devices such as loan flipping, which is described below.

3. Prepayment Penalties

Prepayment penalties are charges a borrower must pay if she wishes to pay off or refinance a loan, either through the same lender or a different one, before the loan term is complete.[58] Prepayment penalties are virtually nonexistent in the prime industry where competition has mostly ended this practice. Seventy percent of loans in the subprime market, however, contain prepayment penalties of approximately five percent of the total loan amount.[59] Because prepayment penalties in a refinance are typically financed as part of the new loan rather than paid at closing, they drive up the cost of the new loan and thereby deplete a borrower's equity.[60] They are particularly objectionable where, as is frequently the case, a borrower was not aware of the prepayment provision in her initial loan.[61] HOSA does not directly limit imposition of prepayment penalties, but does indirectly address the issue by putting a cap on the amount of points that can be refinanced along with high cost loans.

4. Packing Single Premium Insurance Products

Predatory lenders often "pack" unnecessary and costly insurance products to pay off the borrower's loan in the event of sickness, disability or death, into subprime loans and finance them without the borrower's informed consent.[62] Unlike traditional insurance premiums, which are paid on a monthly basis, subprime mortgage insurance products are frequently sold as "single premium" in which five years worth of premiums are paid up front in one lump sum, but financed over the (usually longer) term of the loan. Such single premium credit insurance is abusive because its cost is rarely properly disclosed to borrowers:[63] it is estimated to cost up to four to five times as much as unfinanced premium insurance that the borrower pays periodically.[64] Indeed, a leading consumer advocacy group has called the financing of single premium credit insurance "the worst insurance rip off in the country."[65]

58 HUD-Treasury Joint Report, *supra* note__ at 90.

59 HUD-Treasury Joint Report, *supra* note__at 92.

60 COST OF PREDATORY LENDING, *supra* note __ at 8 (estimating that prepayment penalties on subprime loans cost borrowers $2.3 billion a year).

61 *Id.*

62 HUD-Treasury Joint Report, *supra* note__ at 86-88.

63 COST OF PREDATORY LENDING, *supra* note __ at 6.

64 SEPARATE AND UNEQUAL, *supra* note __ at 42. In addition, lenders have strong incentives to pack such insurance products because they receive an average of 30% commission from the insurance company on the sale. COST OF PREDATORY LENDING, *supra* note __ at 7.

65 Consumers Union, Credit Insurance: The $2 Billion A Year Rip-Off (March 1999), *available at* http://www.consumersunion.org/finance/credit_info_page.htm.

5. Loan Flipping

Loan flipping refers to the practice of repeatedly refinancing a borrower's loan (typically within the first few years of the loan term) with a fee-loaded loan, without reasonable benefit to the borrower.[66] Subprime borrowers are frequently solicited by predatory lenders to refinance their loans with assurances that their monthly payments will be lower (by extending the loan term) or suggestions that they could use cash to consolidate other consumer debts. The refinancings typically contain high points and fees as well as prepayment penalties, which provide additional revenue to lenders and brokers, but materially deplete the equity that borrowers retains in their home.[67] Flipping depends on the skill and confidence of individual lender representatives or brokers, who are persistent in winning the trust of consumers and otherwise assuring them that the time is especially right to take advantage of refinancing.[68] Indeed, loan flipping is a core weapon in predatory lenders' arsenal. Their ultimate goal is to lock a borrower into one abusive loan, and return over and over to the borrower to siphon equity out of her home and into their own pockets.[69] Once a borrower is trapped in this equity-depleting cycle, it becomes next to impossible to escape by refinancing with a legitimate lender on favorable terms.

6. Balloon Payments, Advance Payments, Default Interest Rates and Discretionary Call Provisions

Balloon payments are traditionally a full lump sum payment that occurs at the end of the fixed loan repayment term, which pays off the remainder of what the previous monthly payments did not fully cover.[70] Frequently, victims of predatory lending are either deceived about the existence of a balloon provision in their loan; or such borrowers are falsely reassured that they can refinance at a lower rate in the future when, in fact, predatory lenders will use an impending balloon payment

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66 HUD-Treasury Joint Report, *supra* note__ at 73.

67 For example, in *Cammarano v. Associates*, Civ. No. F-13509-97 (Chanc. Div., Hudson Cty), a woman obtained a $28,000 home equity loan from Associates. After the Ms. Cammarano had difficulty making her payments, Associates initiated contact with her and refinanced the loan three times in two years, increasing her total indebtedness to $56,000, which was primarily comprised of points and fees.

68 Engel and McCoy, *supra* note __ at 1283 ("[p]redatory lenders … endear themselves with charm and guile. They consciously exude an aura of expertise and success, intimidating customers from questioning the advisability of the loans they are offering").

69 Testimony of Jim Dough, *supra* note __ (explaining that predatory finance companies "require branch employees to make contact every three months with customers to prevent payoffs and up-sell to bigger loans. At some of my branches, we tried to call every one of our real estate customers at least once a month. The purpose of these contacts was to flip as many loans as possible. Our tactic was to try to gain the trust and confidence of the customer").

70 HUD-Treasury Joint Report, *supra* note__ at 96.

to force the borrower to accept the flip of the loan so that the lender can extract additional points and fees.[71]

Advance payment provisions require that borrowers prepay a certain amount of interest at closing that would otherwise be payable over the course of the loan.[72] Default interest rate provisions, which substantially increase the interest rate owed upon any default -- sometimes by amounts up to 40% -- can be deeply unfair because they make it very difficult for a borrower to cure a default and set them up for quick foreclosure or refinancing at outrageous terms.[73] Call provisions allow a lender to demand payment of the full loan amount at the lenders' sole discretion.[74] All three provisions are typically included without the borrowers' knowledge and understanding.[75] These provisions also provide an unscrupulous lender the excuse to initiate contact and the leverage to coerce a borrower to refinance with another high-fee loan in order to avoid application of those devastating terms.

7. Negative Amortization

Negative amortization is a type of loan structure in which the monthly payments do not even cover interest charges, causing the principal to increase – rather than decrease – over the life of the loan.[76] Because negative amortization causes a borrower to steadily lose equity each month, it is virtually never in a borrower's interest to accept such a loan term. Not surprisingly, many borrowers report that their unscrupulous lenders did not explain how such loan structure would work.[77]

8. Home Improvement Contractor Abuse

Unscrupulous home improvement contractors frequently pass through poor and minority neighborhoods looking for homes that are in disrepair and therefore susceptible to a home improvement pitch.[78] The contractors will offer to arrange financing with a pre-arranged lender, who agrees to pay the contractor directly from the loan proceeds. Because the borrower is not directly paying the contractor, she has no leverage over the timing or quality of the contractor's work. As a result, unscrupulous contractors can walk away with substantial payments, but leaving the promised repairs unfinished, shabbily done or even

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71 SEPARATE AND UNEQUAL, *supra* note __ at 41.

72 *See* NATIONAL CONSUMER LAW CENTER, STOP PREDATORY LENDING: A GUIDE FOR LEGAL ADVOCATES 46 (2002) ("Some lenders collect these payments upfront at closing to disguise the real amount of credit extended to increase the consumer's obligation to pay interest.").

73 National Consumer Law Center, TRUTH IN LENDING § 10.4.3 (4th ed. 1999).

74 SEPARATE AND UNEQUAL, *supra* note __ at 40.

75 *Id*.

76 HUD-Treasury Joint Report, supra note __ at 91.

77 SEPARATE AND UNEQUAL, *supra* note __ at 41.

78 SEPARATE AND UNEQUAL, *supra* note __ at 39.

unattempted, and leaving the borrower with an unwanted and abusive home equity loan from the complicit lender.[79]

D. Predatory Lending's Wake: An Epidemic Of Foreclosures

Predatory lending has real, measurable and significantly more negative consequences than those associated with other types of consumer fraud. It has caused a rash of foreclosures in New Jersey, causing devastating financial and emotional harm to individual victims and rippling damage throughout the low-income and minority neighborhoods where predatory practices are concentrated.

For example, in Essex County, New Jersey, the number of residential foreclosures increased from 1,701 in 1995 to 2,516 in 2000 as the percentage share of those foreclosures attributable to subprime loans increased from 18.8% to 29.6%.[80] The data appears to demonstrate that foreclosures have not merely tracked the increase in overall subprime lending, but that subprime and predatory lending has prematurely forced disproportionately greater numbers of foreclosures. For example, between 1995 and 2000, the rate of subprime foreclosures was double the rate of subprime originations in Northern New Jersey counties. At the same time, the speed at which loans went into foreclosure – a result of loans that were unmanageable from the start or had serious equity stripping practices – increased dramatically. The average age of a loan in foreclosure dropped from 6.7 years in 1995 to 4.0 years half a decade later.[81] The highest concentrations of defaults are in largely African American sections of southern and western Newark, Irvington and East Orange.[82]

A foreclosure on a residential home puts a family through a devastating period of emotional and financial distress.[83] In addition, when foreclosures are concentrated in particular neighborhoods, once-healthy communities suffer from the externalities associated with largely abandoned tracts of land: a decrease in overall property values, an

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[79] HUD-Treasury Joint Report, *supra* note __ at 39.

[80] PREDATORY LENDING IN NEW JERSEY, *supra* note __ at 8. In the first half of 2001, foreclosures increased an additional 15%. According to the study, these figures are significantly understated because they do not take into account foreclosures accomplished by secondary holders of mortgage notes, which represents approximately half of all subprime mortgage note holders. *Id.*

[81] *Id*. at 6, 8.

[82] *Id.* at 8.

[83] WEICHER, *supra* note __ at 84 (acknowledging that "[t]he consequences [home foreclosure] can be tragic – the loss of a home that may represent all the assets of a family, the necessity of uprooting the family and moving to a less desirable residence"); Eggert, *supra* note __ at 581 (describing range of devastating emotions and problems encountered by families subjected to home foreclosure).

increase in crime, and a corresponding need for greater law enforcement and other government services.[84]

The explosion of foreclosures caused by predatory lending appears more tragic when one considers that the vast majority of victims of predatory lending already owned their homes. Over 80% of subprime lending is not for the purchase of a home, but rather primarily for cash-out refinancings or to consolidate debt.[85] Thus, many homeowners are losing their houses because a complex and new form of consumer debt products has been sold to them on utterly unreasonable terms.[86]

E. The Limitations Of Pre-HOSA Remedies

In enacting HOSA, New Jersey recognized that the phenomenon of predatory lending was too broad and persistent to be controlled by pre-existing remedies. State law misrepresentation remedies typically reach only outright misrepresentation by lenders. Federal disclosure statutes, such as the Truth in Lending Act, are utterly ineffective in warning borrowers about all the pitfalls of predatory loans. Moreover, the federal high cost home loan statute upon which HOSA builds – the Home Ownership Equity Protection Act – includes too small a proportion of home loans within its regulatory scope.

Moreover, much of the effectiveness of these remedies is actually eliminated by the common law holder-in-due-course doctrine, which largely insulates the good faith purchasers of predatory loans from liability for the illegal conduct of loan originators. As described below, HOSA increases loan disclosure requirements, bolsters current consumer fraud protections in the home loan area, supplements protections for classes of high cost loans and, very importantly, eliminates in many cases, the liability barriers created by the holder-in-due-course doctrine.

1. Pre-HOSA Remedies

The New Jersey Consumer Fraud Act ("CFA"),[87] though considered one of the most consumer-friendly statutes in the nation,[88] only applies to misrepresentations, material omissions, or overall unconscionable conduct.[89] While such conduct is obviously present in

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[84] *Senate Special Committee on Aging*, 105th Cong. (1998) (statement of William J. Brennan, Jr. Director, Home Defense Program of the Atlanta Legal Aid Society, Inc.).

[85] Of the 80% of subprime loans that are used for refinancing, 59% are cash-out loans. HUD-Treasury Joint Report, supra note __ at 31.

[86] Mansfied Testimony, *supra* note __ (emphasizing that a large proportion of subprime foreclosures result from subprime debt consolidation refinancings that were misunderstood by the borrower, not really needed or on unfair terms).

[87] N.J. STAT. ANN. 56:8-2.

[88] *Cox v. Sears Roebuck & Co.*, 138 N.J. 2, 15 (1994) (noting that New Jersey has "one of the strongest consumer protection laws in the nation" and should be "construed liberally in favor of consumers.") The Consumer Fraud Act mandates treble damages and attorneys fees. N.J. STAT. ANN. 56:8-2.

[89] *Lemelledo v. Beneficial Mgt. Corp. of America*, 289 N.J. Super. 489 (1996).

many predatory loans – though notoriously difficult to prove – the Consumer Fraud Act does little to prohibit predatory practices such as asset-based lending, loan flipping, insurance fee packing, and financing excessive points and fees. In addition, CFA claims cannot be asserted against the substantial number of secondary market holders of predatory mortgage notes, either as an affirmative claim or as a defense to foreclosure because the holder-in-due-course rule immunizes a good faith purchaser of a note from most claims that could have been asserted against a loan originator, no matter how meritorious the claim is.[90]

Second, the federal Truth in Lending Act ("TILA") mandates certain important disclosures in connection with a home loan including the annual percentage rate (APR), the total amount financed which must include a calculation of points and fees charged, the monthly payment amount and number of payments necessary to pay off the loan entirely.[91] It also authorizes actual damages, statutory damages of double the finance charge and attorneys fees for any violations.[92] However, TILA offers too little in the fight against predatory lending – it fails to include more obvious and less technical disclosures that much of the unsophisticated population that succumbs to predatory lenders needs; too late – the TILA disclosures are made at the loan closing when a borrower has already psychologically committed; and too confusing – the disclosures come included in a bewildering stack of loan documents.[93] In sum, TILA is not sufficient, standing alone, to warn vulnerable borrowers about the true costs of a loan.

Finally, in 1994, Congress enacted the Home Ownership Equity Protection Act ("HOEPA"), which placed direct limits on certain practices if made in connection with a "high cost loan."[94] Specifically, HOEPA protections apply if a loan meets one of two high cost loan triggers: (i) where the APR exceeds by eight percent the yield on Treasury securities of comparable maturity for first lien loans (or above ten percent for subordinate lien loans) (the "rate trigger" or "APR trigger"); or (ii) where the total of all the loan's points and fees exceeds eight percent of the loan total or $400 (adjusted for inflation), whichever is greater (the "fee trigger").[95] Regulation Z, promulgated under HOEPA by the Federal Reserve Board, specifies which charges count as

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[90] *See* text accompanying *infra* notes __ to __. .

[91] 15 U.S.C. § 1638.

[92] 15 USC §1640(a)(1)-(3).

[93] *See generally* Christopher L. Peterson, *Truth, Understanding and High Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807, 881-83 (2003) (describing serious problems TILA has for controlling fraud in the home loan context).

[94] 15 U.S.C. § 1601 (2002)

[95] 15 U.S.C. § 1602(aa)(1), 3 (2000), 12 C.F.R. § 226.32(a)(1)(i) (2002). The fee trigger was lowered by Federal Reserve Board in 2001, from ten percent above comparable Treasury securities (for either first or second lien loans). 66 Fed. Reg. 65606, 65608-65610 (Dec. 20, 2001).

points and fees to be included in the fee trigger and includes compensation to a mortgage broker in the form of a yield spread premium[96] and, after recent amendments to Regulation Z, optional credit insurance.[97]

HOEPA prohibits inclusion of certain loan terms in high cost loans that tend to be predatory. For such loans, HOEPA prohibits negative amortization without exception,[98] balloon payments on loans with terms of five or fewer years,[99] loan terms that increase the interest rate in the event of a default,[100] and prepayment penalties in certain cases for financially vulnerable borrowers.[101] HOEPA creditors are prohibited from engaging in asset-based lending – lending without regard to a borrower's ability to pay[102] – but only if they have engaged in a "pattern or practice of such activity."[103] Recent amendments to Regulation Z also place limits on loan flipping: creditors or their affiliates are forbidden from refinancing a HOEPA-covered loan within a year, unless the refinancing is "in the borrowers' interest."[104] Damages for violations of HOEPA include all those available under TILA plus enhanced statutory

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96 15 U.S.C. § 1602(aa)(4)(B), 12 C.F.R. § 226.32(b)(1)(ii).

97 12 C.F.R. § 226.32(a)(1)(ii), (b)(1)(iv). Real estate charges such as title insurance, filing and recording fees must also be included unless the charges are reasonable, offers no direct or indirect compensation to the creditor, and is paid to a third party unaffiliated with the creditor. 12 C.F.R. § 226.32(b)(iii).

98 15 U.S.C. § 1539(f); 12 C.F.R. § 226.32(d)(2).

99 15 U.S.C. § 1639(e); 12 C.F.R. § 226.32(d)(1); Official Staff Commentary, § 226.32(c)(3). For loan terms that exceed five years, balloon payments are permissible, but must be disclosed. *See* text accompanying *supra* note __.

100 15 U.S.C. § 1639(d); 12 C.F.R. § 226.32(d)(4).

101 Prepayment penalties are permitted only if (i) the loan will not cause the borrower to pay more than fifty percent of their income to the monthly payments; (ii) income and expenses are verified by financial statement signed by the consumer and supported by a credit report; (iii) creditor is not refinancing one of its own or an affiliate's loans; (iv) if it occurs within the first five years of the loan; and (v) the penalty is legal under state law. 15 U.S.C. § 1639(c).

102 HOEPA defines this conduct as extending credit "based on the consumer's collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment." 15 U.S.C. § 1639(h).

103 Traditionally, the pattern or practice element of the prohibition has been a hard one for plaintiffs to satisfy, requiring proof of several instances of prohibited conduct in short period of time. *Newton v. United Companies Financial Corp.*, 24 F. Supp. 2d 444, 457 (E.D. Pa. 1998). The recent amendments have loosened the requirement somewhat, creating a presumptive violation where the lender has failed to document and verify the borrower's ability to pay. 66 Fed. Reg. 65606, 65608-65610 (Dec. 20, 2001).

104 12 C.F.R. § 226.34(a)(3) (2002). In considering whether a refinancing is in the borrower's interest, Regulation Z instructs lenders to consider the totality of the borrower's circumstances at the time the credit was extended. *Id.*

damages in the amount of the sum of all finance charges and fees paid by the consumer.[105]

HOEPA's scope, however, is narrow in two important respects. First, HOEPA does not cover purchase money mortgages (that is, those used to purchase homes) or open-end lines of credit (such as home equity lines of credit).[106] Moreover, as consumer advocates have been arguing for years, the HOEPA high cost loan triggers are too high. Predatory lenders are notoriously successful for offering loans at rates and with points and fees just below the high HOEPA triggers and thereby evading regulation.[107]

2. Holder-in-due-course Rule's Elimination of Assignee Liability

Another significant limitation on remedies available to victims of predatory lending is the Uniform Commercial Code's holder-in-due-course rule.[108] The rule insulates noteholders in the secondary market from most defenses by borrowers – including fraud-related ones – which the borrower could have raised against the original creditor.[109] The FTC has fully abrogated the holder-in-due course rule's application to the sale of "consumer goods," which makes the rule unavailable to assignees of loans involving manufactured homes or home improvements.[110] Similarly, HOEPA has abrogated the rule for loans it covers, making good faith assignees potentially liable for all claims and subject to all defenses a debtor could have raised against the loan originator unless the assignee can demonstrate that "a reasonable person exercising due

[105] 15 U.S.C. § 1640(a). HOEPA, like TILA, has a one-year statute of limitations for affirmative suits, but can be raised any time – including against assignees – as a defense to foreclosure. 15 U.S.C. §. 1640(c).

[106] Open-end credit is a credit extension where the exact amount of money lent or advanced at any given time is not fixed. 15 U.S.C. §1602(i). It is, in short, a line of credit. In order to qualify as an open-end loan, TILA and Regulation Z require that creditors demonstrate that their credit plan meet three specific elements. A creditor under a plan must: (i) reasonably contemplate repeated transactions; (ii) may impose a finance charge from time to time on an outstanding unpaid balance; and (iii) generally replenishes the amount of credit available to the consumer to the extent that any outstanding balance is repaid. 15 U.S.C. §1602(i); 12 C.F.R. §226.2(a)(20). Open-end lines of credit are being more frequently used in the home loan context.

[107] TRUTH IN LENDING *supra* note __ at §10.1.1.

[108] U.C.C. §3-302 (2003). The rule applies to purchasers of mortgages if they are: (1) a holder; (2) of a negotiable note; (3) who took the note for value; (4) in good faith; (5) without notice of the defenses to the note. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §14-2 (4th ed. 1995).

[109] The only "real" defenses that survive the protections for good faith noteholders are severely limited. They include infancy, duress, lack of legal capacity or illegality of transaction, fraud in the factum involving, for example, forged signature, insolvency of the debtor. WHITE AND SUMMERS, *supra* note __ §14-10.

[110] FTC Holder in Due Course Regulations, 16 C.F.R. § 433.2 (1978).

diligence" could not have revealed that the loan was covered by HOEPA.[111]

Nevertheless, in the large category of non-HOEPA home purchase or refinance loans that are sold to the secondary market, the holder-in-due-course rule poses a substantial impediment to borrowers seeking redress for predatory loans and likewise renders them virtually helpless to contest foreclosures brought by secondary market mortgage noteholders, no matter how abusive or fraudulent the underlying loan.[112] As a result, the holder-in-due course rule creates little incentive for the secondary market to police predatory practices of loan originators. Consumer advocates have persistently argued, therefore, that for any remedy for predatory lending to be fully effective, it must include a provision that imposes liability against assignees of abusive loans both to offer borrowers protection against foreclosure and to force the secondary market to cut off funding to predatory lenders.[113]

II. THE NEW JERSEY HOME OWNERSHIP SECURITY ACT: ATTEMPTING TO CURB THE WORST AND PROTECT THE BEST OF THE SUBPRIME MARKET

On May 1, 2003, Governor James McGreevey signed the New Jersey Home Ownership Security Act ("HOSA" or the "Act") into law.[114] It will apply to most New Jersey purchase money and home equity loans that close on or after November 27, 2003.[115] The stated purpose of the Act is to "encourage lending at reasonable rates with reasonable terms" so as to strengthen the viability of many communities and increase home ownership.[116] HOSA is designed to accomplish this goal by prohibiting certain mortgage lending practices deemed either categorically unjustifiable or abusive when made in connection with loans that already have very high interest rates or points and fees structures. Consumer advocates consider the Act a landmark measure that will protect New Jersey's most financially vulnerable homeowners from predatory lenders and offer a reprieve against the rash of unfair

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111 15 U.S.C. § 1641(d)(1). Due diligence requires that the purchaser examine all loan documentation required by TILA plus the itemization of amount financed and any other disclosures. TRUTH IN LENDING, *supra* note __, §10.7.2 (4th ed. 1999).

112 *See*, Eggert, *supra* note __ at __ -__ (discussing substantial costs securitization and the holder-in-due-course rule have imposed in the subprime mortgage market).

113 *See, e.g.* Eggert, *supra* note __ at 617 ("the surest solution to the problem of predatory lending is to force the markets that fund subprime lenders to police those lenders, and the surest way to force this private policing effort is to ensure that the buyers of predatory loans bear any risk of loss associated with the sharp practices of the lender, rather than having that loss borne by the lender.")

114 N.J. STAT. ANN. 46:10B-22, *et seq*. (2003).

115 N.J. STAT. ANN. 46:10B-35(15) (2003); *see* N.J. STAT. ANN. 46:10B-31 (10) (2003); N.J. Department of Banking and Insurance Bulletin No. 03-15, at 1 (July 25, 2003).

116 N.J. STAT. ANN. 46:10B-23(2)(b)-(c) (2003).

home foreclosures that are concentrated in New Jersey's minority and low-income neighborhoods.[117]

Members of the subprime lending industry, argue that the Act is unnecessary in light of existing remedies and may even be counterproductive, but nevertheless agree that the Act will significantly alter subprime lending practices in the state.[118] Industry representatives also argue that the Act is ambiguous and fails to give creditors sufficient guidance as to how they should comply with the new law.[119] The subprime lending industry has looked to the New Jersey Department of Banking and Insurance ("DOBI") for additional guidance. But, while the New Jersey legislature has given DOBI significant investigatory and enforcement powers under the Act,[120] it has granted DOBI only limited regulatory authority to interpret the Act.[121]

Indeed, DOBI has only been authorized to promulgate regulations to effectuate the Act's provisions relating to (i) mandatory disclosure notices and loan counseling programs for prospective High Cost Home Loan borrowers and (ii) additional consumer counseling and awareness programs for all prospective Home Loan borrowers. DOBI, notwithstanding its lack of statutory authority, has issued a Bulletin to provide guidance to potential creditors as to the meaning of a number of

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[117] *See, e.g.*, Ken Zimmerman and Linda Fisher, *Progress in the Fight against Predatory Lending*, THE NEWARK STAR-LEDGER, May 16, 2003, at 23 (023 2003 WL 55555939); *see also* Editorial, *Predatory Lending*, NEW JERSEY LAW JOURNAL, May 12, 2003 (NJ enacts a "national model in state legislative efforts to combat the range of abusive mortgage lending practices collectively referred to as predatory lending."); MBANJ Backs Compromise, Origination News, April 2003.

[118] Jim Goryeb, *Loan Law is a Bad Risk for Jersey*, THE NEWARK STAR-LEDGER, May 9, 2003 at __ (031 2003 WL 19921382).

[119] ReedSmith, LLP, *A. 75 New Jersey's New Anti-Predatory Lending Law*, Client Bulletin 2003-37, at 6 (May 2003), *available at* http://www.reedsmith.co.uk/library/publicationMore.cfm?currentpage=2&catid=14&archive=1.

[120] The Act provides DOBI with significant investigatory powers. *See* N.J. STAT. ANN. 46:10B-28(7)(a)-(c). It also provides DOBI with substantial remedial powers for violations of the Act, authorizing DOBI to: impose civil penalties of up to $10,000 for each offense, suspend, revoke or refuse to renew any license issued by DOBI; remove from her position a person responsible for a violation of the Act; order a person to cease and desist from any violation of the Act and make restitution to borrowers for damages; and any other conditions that the Department deems necessary and appropriate. N.J. STAT. ANN. 46:10B-28(7)(d) (2003).

[121] When the Act was initially pre-filed for introduction into the 2002 New Jersey legislative session, it contained the language, "the Commissioner of Banking and Insurance shall promulgate regulations pursuant to the "Administrative Procedure Act," P.L.1968, c.410 (C.52:14B-1 et seq.) *necessary to effectuate the provisions of this act*." Bill S. 2187 § 12 as Introduced and Referred To Senate Commerce Committee (Mar. 8, 2001) (emphasis added). This language clearly granted DOBI a broad mandate to interpret the Act. The final version of the bill, however, was revised to read, "necessary to effectuate the provisions of subsections f. and g. of section 5 and section 11 of this act." N.J. STAT. ANN. 46:10B-35(14) (2003).

the Act's ambiguous provisions.[122] While such guidelines are not binding, they have some persuasive authority, given DOBI's mandate to protect and educate "consumers and promotes the growth, financial stability and efficiency of" the banking industry.[123] Nonetheless, where DOBI's guidance is inconsistent with the plain text of the Act (as we demonstrate in several places in this Article), its authority is obviously significantly reduced.

A. The Act's Scope: Regulating Most Home Loans A Little, But High Cost Home Loans A Lot

The Act designates three classes of loans – "home loans," "covered loans," and "high cost loans" – and subjects creditors who issue them, as well as the secondary market investors who purchase them, to increasing levels of regulation. The New Jersey legislature concluded that the Act's prohibitions on practices associated with the extremely broad category of Home Loans, such as financing single premium credit insurance and encouraging borrowers to default, are per se unreasonable in the mortgage context and can virtually never be economically justified.[124] The legislature also appears to have recognized that high cost loans, ones that have either very high rates or points and fees structures, render borrowers increasingly susceptible to default and foreclosure and, at the same time, are typically extended to borrowers that are low-income, financially unsophisticated, and thereby particularly vulnerable to the abuses of predatory lenders. Accordingly, the Act bans numerous additional loan terms when made in connection with high cost loans, such as balloon payments, negative amortizations, default interest rates, while also mandating clear disclosures and, in certain cases, loan counseling.[125] Undoubtedly reflecting a legislative compromise, the Act bans the particularly dangerous practice of loan flipping for "Covered Home Loans," a category somewhat broader than high cost loans.

1. Application to Creditors

The Act only governs only Home Loans made by "creditors," defined as those who extend consumer credit that is (i) subject to a finance charge or (ii) payable by five or more installments and to whom the obligation is payable at any time.[126] This definition appears intended to screen out informal lenders, such as family members who do not extend "consumer credit." Notably, the term "creditor" also includes mortgage brokers as well as anyone who directly or indirectly solicits, processes, places or negotiates Home Loans for others, which ensures that all parties who are involved in arranging financing are subject to its prohibitions and penalties.[127] It also ensures that those who finance – but do not arrange –Home Loans cannot avoid regulation by assigning various lending tasks, such as solicitation and origination to different

[122] N.J. Department of Banking and Insurance Bulletin No. 03-15 (July 25, 2003).
[123] DOBI Mission Statement, *at* http://www.state.nj.us/dobi/dobimiss.htm.

entities.[128] This broad definition of creditor appears to include home improvement contractors and manufactured home sellers who have significant involvement in arranging a Home Loan.[129]

2. Three Tiers of Home Loan Coverage

The Act classifies three types of residential mortgage loans and subjects each to different levels of regulation. First, the Act defines the very broad category of "Home Loans" as extensions of credit to borrowers secured by either: (i) a mortgage or deed of trust on real estate for a one-to-six family dwelling that is or will be occupied by the borrower as her principal dwelling; or (ii) a security interest in a "manufactured home"[130] which is or will be occupied by a borrower as her principal dwelling.[131] Exceeding the scope of protections offered by HOEPA, the Act also covers purchase money mortgages (for initial home purchases) and open-ended lines of credit;[132] like HOEPA, the Act does excludes "reverse mortgage transactions" from its regulatory

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124 N.J. STAT. ANN. 46:10B-24(3) (2003).

125 N.J. STAT. ANN. 46:10B-26(5)(a)-(g) (2003).

126 N.J. STAT. ANN. 46:10B-24(3) ("Creditors") (2003).

127 N.J. STAT. ANN. 46:10B-24(3) ("Creditors") (2003).

While including mortgage brokers within the definition of "Creditor," the Act also provides a meaningful limitation for the scope of that liability:

> Notwithstanding any provision of this act to the contrary, a mortgage broker shall be
> liable under the provisions of this act only for acts performed by the mortgage broker in the course of providing mortgage brokering services. However, a mortgage broker may be held liable for acts performed by the mortgage broker outside the scope of mortgage brokering services if the acts are related to the purchasing or the making of a home loan and are otherwise prohibited under this act.

N.J. STAT. ANN. 46:10B-33(12) (2003). Thus, a mortgage broker acting *qua* mortgage broker is only liable for her own violations of the Act and is not jointly and severally liable along with the creditor for the creditor's actions. The Act also excludes from the definition of creditor, attorneys and title insurers who are unaffiliated with the lender. *Id*.

128 See Eggert, supra note__ at (describing how lending industry structures itself to avoid liability to borrowers).

129 *See* N.J. STAT. ANN. 46:10B-24(3) ("Creditor") (2003).

130 The category of manufactured homes includes modular homes, panelized homes, pre-cut homes, and mobile homes. Manufactured Home Institute Website, *at* http://www.manufacturedhousing.org/lib/showtemp_detail.asp?id=74&cat=1 (last visited August 29, 2003).

131 N.J. STAT. ANN. 46:10B-24(3) ("Home Loan") (2003).

132 Open-end credit plans represent a credit extension where the exact amount of money lent or advanced at any given time is not fixed. *See* 15 U.S.C. §1602(i) (2003). Because open-end home equity lines of credit have been increasingly utilized by borrowers, including subprime borrowers, HOSA's express regulation of such loans is a significant increase of scope over that of HOEPA. *See supra* note __.

scope.[133] The large majority of residential mortgage loans in New Jersey would fall into the Act's classification of Home Loans. By definition, Home Loans include the more restrictive categories of Covered Home Loans and High Cost Home Loans, which are described below.

Second, the Act classifies certain subset of Home Loans as "Covered Home Loans," which are defined by reference to a points and fees trigger that is lower than those for High Cost Loans (defined below) and therefore covers a broader proportion of high-fee loans. Covered Home Loans are Home Loans where the total points and fees payable in connection with the loan exceed (i) four percent of the total loan amount for loans of more than $40,000 or (ii) four and a half percent of the total loan amount if it is $40,000 or less or if it is insured by the Fair Housing Administration ("FHA") or guaranteed by the Department of Veterans Affairs ("VA").[134] Excluded from the definition of points and fees are conventional prepayment penalties or not more than two "bona fide discount points" ("BFDP," defined below).[135] The definition of Covered Home Loans contains no cap for the principal amount of such loans. In addition, by definition, Covered Home Loans include all High Cost Home Loans.[136]

Finally, "High Cost Home Loans" – the narrowest and most heavily regulated subset of loans – are Home Loans with a principal amount of less than $350,000 (such amount to be adjusted annually)[137] that, like a HOEPA-covered loan, exceeds a specified interest rate or points and fees threshold. The interest rate threshold under HOSA is defined by incorporating the APR triggers set by HOEPA and the Federal Reserve Board's Regulation Z.[138] Thus, HOSA's interest rate

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133 Reverse mortgage transactions are mortgages that reverse the direction of payments. They are typically used by older homeowners, who can borrow against the substantial equity in their homes to receive periodic cash payments. Repayment of the loan amount is not required until the borrower transfers the dwelling, ceases to occupy it as a primary residence or dies. *See* Truth in Lending Act, 15 U.S.C. § 1602(bb) (2003).

134 N.J. STAT. ANN. 46:10B-24(3) ("Covered Home Loan") (2003).

135 N.J. STAT. ANN. 46:10B-24(3) ("Covered Home Loan") (2003). For example, (and excluding up to two bona fide discount points), a $100,000 Home Loan would be a Covered Home Loan if its points and fees were more than $4,000; a $10,000 Home Loan would be a Covered Home Loan if its points and fees were more than $450; and a $100,000 VA or FHA Home Loan would be a Covered Home Loan if its points and fees were more than $4,500.

136 N.J. STAT. ANN. 46:10B-24(3) ("Covered Home Loan" (2)) (2003).

137 N.J. STAT. ANN. 46:10B-24(3) ("High Cost Home Loan") (2003). The $350,000 threshold will be adjusted each year to include the last published increase of the housing component of the national Consumer Price Index, NY-Northeastern NJ Region. By way of example, that component increased 4% from July 2002 to July 2003. United States Department of Labor, *New York-Northern New Jersey CPI Up 0.4 Percent In July; 3.0 Percent Increase From Year Ago* (available at http://www.bls.gov/ro2/cpinynj.htm). Last checked August 29, 2003.

138 N.J. STAT. ANN. 46:10B-24(3) ("Threshold" (1)) (2003). See 15 U.S.C. § 1602(aa) (2003); 12 C.F.R. § 262.32 (2003). This determination is made without

trigger, like HOEPA's, is eight percent above the prevailing interest rate on a Treasury security of a comparable maturity for first lien mortgages, and ten percent above the prevailing Treasury security rate for a second lien mortgage.[139] At the time HOSA was enacted (May 1, 2003), a twenty- year fixed interest Treasury security (the relevant comparable security for a thirty year mortgage) carried an interest rate of 4.93%.[140] Accordingly, under both HOEPA and HOSA, only those loans with an APR of 12.93% or higher would be classified and regulated as High Cost Loans.[141] Indeed, the High Cost Loan threshold averages approximately a full seven percent above the national average interest rate of 5.7% for a fixed rate 30-year home loan measured at the time of HOSA's passage[142] and, therefore covers a narrow category of very expensive loans.

Under HOSA, the classification and heavy regulation of a home loan as a High Cost Home Loan is also triggered if the loan meets a certain "total points and fees threshold."[143] HOEPA's points and fees threshold is set fairly high, at eight percent of the total loan value.[144]

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regard to whether the loan transaction is or may be a "Residential Mortgage Transaction," as defined in 12 C.F.R. § 226.2(a)(24) (2003). N.J. STAT. ANN. 46:10B-24(3) ("Threshold"(1)) (2003). A Residential Mortgage Transaction is a loan to finance the acquisition or initial construction of a principal dwelling. 12 C.F.R. § 226.2(a) (24) (2003). While such types of loans do not fall within the ambit of HOEPA, they do fall within that of HOSA. Thus, HOSA, unlike HOEPA, applies to purchase money and construction mortgages for primary dwellings.

139 *See* 15 U.S.C. § 1602(aa)(1) (2003), 12 C.F.R. § 226.32(a)(1)(i) (2003). HOEPA's APR trigger had been lowered by the Federal Reserve Board in 2001, from a threshold of ten percent (for both first and second lien loans) above comparable Treasury securities. 66 Fed. Reg. 65606, 65608-65610 (Dec. 20, 2001).

140 Federal Reserve Statistical Release H.15 Selected Interest Rates. April 21, 2003, at http://www.federalreserve.gov/Releases/H15/20030421/ (last checked August 29, 2003). The HOEPA and HOSA trigger for a first-lien mortgage is eight points above "the yield on Treasury securities having comparable periods of maturity to the loan maturity as of the fifteenth day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor." 12 C.F.R. § 226.32(a)(1)(i). Because the federal government has recently stopped issuing 30-year Treasuries, the Federal Reserve Board staff has interpreted the Regulation Z trigger language to mean that lenders should use the yield for 20-year constant maturities in place of the yield for 30-year maturities. 12 C.F.R. § 226.32(a)(1)(i) Comment. 226.32(a)(1)(i)-4(iii). These yields may be determined from the Board's "Selected Interest Rates" (statistical release H-15). Id. at Comment. 226.32(a)(1)(i)-4.

141 As the yield for 20-year constant maturities on April 15th, 2003, was 4.93%, the precise HOEPA rate trigger for a thirty-year fixed interest loan for which the creditor received the application on May 1, 2003 (the day the Act was signed) is 12.93%.

142 *See* Freddie Mac Primary Mortgage Market Survey Weekly Mortgage Market Survey 2003 Weekly Mortgage Rates Releases (available at http://www.freddiemac.com/learn/cgi-in/dLink.cgi?jp=/PMMS/display/PMMSOutputYr.jsp&ENV=PROD). (last checked August 29, 2003). The points and fees national average for loans during that period is .6 percent. *Id.*

143 N.J. STAT. ANN. 46:10B-24(3) ("Total Points And Fees Threshold") (2003).

144 15 U.S.C. § 1602(aa)(3) (2003).

HOSA's points and fees threshold is uniformly lower than HOEPA's, but employs a sliding scale, allowing lenders to charge higher points and fees – and avoid a loan's High Cost designation – for loans that have lower values. Under the Act, the points and fees trigger is met where the borrower is charged, at loan closing: (i) for total loan amounts of $40,000 or greater, five percent or more of the total loan amount; (ii) for total loan amounts of $20,000 to $39,000, six percent of the total loan amount; and (iii) for total loan amounts of $1 to $19,999, the lesser of $1000 or six percent.[145] The Act specifically excludes from the calculation of points and fees "conventional prepayment penalty"[146] and up to two bona fide discount points, as explained in detail below.

3. Calculation of the Total Points and Fees Trigger

The federal Truth in Lending Act specifically mandates the disclosure of a loan's annual percentage rate – a standardized form of interest rate calculation – to encourage loan price transparency and thereby provide consumers with a clearer understanding of the cost of a loan.[147] The imposition of high points and fees, which appear almost invariably with subprime and all predatory loans, are far more confusing. Indeed, one of the persistent abuses in the home loan market have been lenders' efforts to add charges to a loan that were not required by federal law to be reflected in the loan's APR.[148] HOEPA and now HOSA attempt to set forth a comprehensive list of charges that must be included in calculating a loan's points and fees and therefore possibly trigger classification as a Covered or High Cost Home Loan. However, by including several items in the catalogue of charges that are specifically excluded from the HOEPA points and fees threshold calculation, HOSA will shift a greater proportion of Home Loans into its heavily regulated

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145 N.J. STAT. ANN. 46:10B-24(3) ("Total Points And Fees Threshold") (2003). For example, (and excluding up to two bona fide discount points), a $100,000 Home Loan would be a High Cost Home Loan if its points and fees were $5,000 or more; a $30,000 Home Loan would be a High Cost Home Loan if its points and fees were $1,800 or more; and a $18,000 Home Loan would be a High Cost Home Loan if its points and fees were $1,000 (that is, the lesser of $1,000 or 6% of the loan amount).

146 A "conventional prepayment penalty" is "any prepayment penalty or fee that may be collected or charged in a home loan, and that is authorized by law other than by this act, provided the home loan (1) does not have an annual percentage rate that exceeds the conventional mortgage rate by more than two percentage points; and (2) does not permit any prepayment fees or penalties that exceed two percent of the amount prepaid." N.J. STAT. ANN. 46:10B-24(3) ("Conventional Prepayment Penalty") (2003).

147 15 U.S.C. § 1601(a) (TILA's purpose is to "assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit"); *Schnall v. Amboy Nat. Bank*, 279 F.3d 205, 219 (3rd Cir., 2002). *Rossman v. Fleet Bank (R.I.) Nat. Ass'n*, 280 F.3d 384, 389 (3rd Cir. 2002); *see also* TRUTH IN LENDING, *supra* note __ at 33 (TILA is "Congress's effort to guarantee the accurate and meaningful disclosure of the costs of consumer credit and thereby to enable consumers to make informed choices in the credit marketplace.").

148 TRUTH IN LENDING, 2002 Supplement, *supra* note ___ at 209.

categories. While HOSA's exclusion of up to two "bona fide discount points" from the points and fees calculation appears to provide additional flexibility for lenders, the provision will most likely never affect the classification of High Cost Loans for reasons discussed below.[149]

[149] *See* text accompanying *infra* notes __ to __.

a) Calculation of Points and Fees

Under the Act, the following charges must be included in calculating a loan's Total Points and Fees Trigger: (1) all items, other than interest and a time price differential, listed in Section 1605(a)(1)-(4) of TILA, which includes all points, origination fees, service charges and other charges by the lender such as a loan fee, finder's fee or investigation or credit report fee;[150] (2) all closing-related costs specifically listed in Section 1605(e) of TILA;[151] (3) all compensation paid directly or indirectly to a mortgage broker;[152] (4) the cost of all premiums financed by the creditor, directly or indirectly, for any credit insurance;[153] (5) the maximum loan prepayment fees and penalties that could be charged in connection with the loan and all prepayment fees or penalties actually that are actually incurred by a borrower if the loan is refinancing a previous loan held by the same creditor (or its affiliate).[154]

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[150] N.J.S.A 46:10B-24(3)(1) (2003). Section 1605(a) lists items that must be included in HOEPA's points and fees calculation. HOSA incorporates into its definition of points and fees, the following items (excluding interest and the time price differential):

> (1) any amount payable under a point, discount, or other system or additional charges;
> (2) service or carrying charge
> (3) loan fee, finders fee, or similar charge
> (4) fee for an investigation or credit report.

See 15 U.S.C. § 1605(a)(1) (2003).

[151] N.J.S.A 46:10B-24(3)(2) (2003). Under Section 1605(e), these charges are actually *excluded* from HOEPA's points and fees calculation. Section 1605(e) reads as follows:

> The following items, when charged in connection with any extension of credit secured by an interest in real property, shall not be included in the computation of the finance charge with respect to that transaction:
> (1) Fees or premiums for title examination, title insurance, or similar purposes.
> (2) Fees for preparation of loan-related documents.
> (3) Escrows for future payments of taxes and insurance.
> (4) Fees for notarizing deeds and other documents.
> (5) Appraisal fees, including fees related to any pest infestation or flood hazard inspections conducted prior to closing.
> (6) Credit reports.

15 U.S.C. § 1605(e) (2003). HOSA treats the items listed in section 1605(e) in the opposite manner of TILA by *including* them in its points and fees calculation. Section 1605(e), like section 1605(a) references "credit reports," making HOSA redundant in this small way.

[152] N.J.S.A 46:10B-24(3)(3) (2003). This provision would force lenders to reflect as a real cost to borrowers the indirect compensation paid to brokers by creditors that in the form of a yield spread premium. Yield spread premiums tend to encourage brokers to charge borrowers a higher interest rate. *See* text accompanying *supra* note __; *see also* HOEPA, 15 U.S.C. § 1602(aa)(4)(B) (2003) (requiring that "all compensation paid to mortgage brokers" be included in the total points and fees calculation).

[153] N.J. STAT. ANN. 46:10B-24(3) (2003).

[154] N.J.S.A 46:10B-24(5),(6) (2003). As discussed below, unlike other state predatory lending legislation and HOEPA itself, HOSA does not place any express

For the purposes of the Act, "Points and Fees" do not include the following: (1) title insurance premiums and fees;[155] (2) taxes, filing fees, and recording and other charges paid to public officials for perfecting or satisfying a security interest; (3) certain "reasonable" fees paid to person unaffiliated[156] with either the creditor or the mortgage broker,[157] for tax payment services, flood certification, pest, flood, appraisal and inspection fees, attorney's or notary's fees, escrow charges[158] and fire and flood insurance premiums, provided that such premiums are purchased from an entity that is not affiliated with the creditor or certain disclosures are made.[159]

Notably, HOSA's definition of Points and Fees in places, is either moot, inconsistent or confusing. First, the Act's inclusion of financed premium insurance is rendered moot by Section 10B-25(4)(a) of the Act, which categorically prohibits the inclusion of any single premium credit insurance in the first place in *any* Home Loan. No lender will ever calculate the cost of such insurance because no lender will be permitted to even charge for such a product. Perhaps the New Jersey legislature relied too reflexively on the points and fees calculations set forth in HOEPA, which requires that charges for single premium credit insurance be calculated as part of the HOEPA points and fees trigger, *see* 12 C.F.R. § 226.32(b)(iv), but which does not otherwise prohibit the imposition of such insurance charges.

Second, again by incorporating by reference portions of HOEPA, the Act creates an apparent inconsistency as to whether title insurance fees should be included in the Points and Fees calculation. On the one hand, "Points and Fees" includes by reference to Section 1605(e)(1) of TILA, "fees or premiums for title examination, title insurance, or similar

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limitation on the imposition prepayment penalties on High Cost Home Loans. *See* text accompanying *infra* notes __ to __.

[155] N.J.SA. 46:10B-24(3)("Points and Fees"). As described below, this exclusion appears to contradict the inclusion of title insurance premiums in the points and fees calculation required elsewhere in the Act. *See* N.J. STAT. ANN. 46:10B-24(3) ("Points and Fees" (2)) (2003).

[156] Affiliate is defined by the Act with reference to the definition set forth in 12 U.S.C. § 1841 ("any company that controls, is controlled by, or is under common control with another company"). *See* N.J. STAT. ANN. 46:10B-24(3) ("Affiliate") (2003).

[157] These exclusions from "Points and Fees" incorporates "the conditions" in 12 C.F.R. § 226.4(c)(7) (2003), which are actually listed in 12 C.F.R. § 226.32(b)(1)(iii) (2003).

[158] *See* text accompanying infra notes __ to __ regarding the Act's ambiguous treatment of escrows.

[159] These conditions relating to premiums have been incorporated from 12 C.F.R. § 226.4(d)(2) (2003). N.J. STAT. ANN. 46:10B-24(3) ("Points and Fees") (2003). That regulation states that "(i) Insurance coverage may be obtained from a person of the consumer's choice, and this fact is disclosed. (ii) If the coverage is obtained from or through the creditor, the premium for the initial term of insurance coverage shall be disclosed. If the term of insurance is less than the term of the transaction, the term of insurance shall also be disclosed." 12 C.F.R. § 226.4(d)(2) (2003).

purposes."[160] On the other hand, the Act expressly excludes from the definition of "Points and Fees," "title insurance premiums and fees, charges and premiums paid to a person or entity holding an individual or organization insurance producer license in the line of title insurance or title insurance company, as defined by" New Jersey's title insurance licensing law.[161] Perhaps the best way to harmonize this apparent inconsistency is to read the former provision in this portion of the Act as broader than and inclusive of the latter; that is, the former category covers title fees paid to all parties, while the latter category covers title fees paid only to licensed title insurers. Thus, by subtracting the smaller from the broader category, what remains and must be included in the definition of Points and Fees, is title fees to unlicensed title service providers. For instance, traditional title insurance premiums, paid to a third-party provider, would be excluded from the definition, while any fees collected by a creditor in connection with title issues – such as some kind of referral fee – would be included.

Finally, the Act creates some confusion about whether or in what form escrow charges should be included in the calculation of Points and Fees. On the one hand, the Act includes escrows for future payments of taxes and insurance; on the other hand the same subsection of the Act excludes bona fide and reasonable escrow charges paid to a person other than a creditor or its affiliate or to the mortgage broker or its affiliate. Textually, those two sections seem to mean that escrows for future payments of taxes and insurance that are either (x) paid to the creditor, mortgage broker or one of their affiliates or (y) that are neither bona fide nor reasonable, are included in the definition of Points and Fees.

Although this appears to be the most coherent reading of the text, this treatment of escrows is inconsistent with standard lending practices in the prime market in which the retention of reasonable escrows is common.[162] It would seem more consistent with the Act's purposes if only those escrow charges that were in excess of reasonable escrowed taxes and fees and insurance premiums were included within the definition of Points and Fees. Notwithstanding this, the inclusion of a reasonable escrow should only make up a very small portion of the Points and Fees and so, perhaps, their inclusion may have been purposeful.

b) Exceptions for Bona Fide Discount Points ("BFDP")

In the conventional loan market, lenders frequently charge points in exchange for a lower loan interest rate than the borrower would

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160 15 U.S.C. § 1605(e)(1)

161 N.J. STAT. ANN. 46:10B-24(3) ("Points and Fees") (2003).

162 Indeed, the New Jersey Department of Banking has taken the position that such escrows are not included within the ambit of Points and Fees: N.J. Department of Banking and Insurance Bulletin No. 03-15 (7/25/03) at 7.

otherwise receive. Discount points most benefit borrowers who can recoup their initial point investment by paying the bargained for lower interest rate over a long period of time. The Act recognizes the value of such an exchange by excluding from both the Covered Home Loan threshold or the High Cost Home Loan Points and Fees threshold, up to two "bona fide discount points."

According to the Act, in order for loan discount points to be "bona fide", they must meet two criteria: (i) the interest rate on the loan that is being discounted, prior to the application to the discount points, must be at most two points above the conventional mortgage rate[163] for first lien mortgages (and or at most three-and-a-half points for junior lien mortgages); and (ii) they must be knowingly paid by the borrower for the express purpose of, and in fact reducing, the loan's interest rate; so that (iii) the borrower recovers an amount equal to such loan discount points within the first five years of the scheduled loan payments.[164]

Because High Cost Home Loans typically have interest rates that far exceed two points above the conventional mortgage rate, the bona fide discount point exclusion will have a relatively minor effect on that category of loans. The exclusion may apply to the rare case of a loan that is classified as High Cost solely by virtue of its high points and fees structure, but that otherwise has an interest rate that is within two points of the conventional mortgage rate.[165] The bona fide discount point exclusion will certainly have a greater impact on the Covered Home Loan category, because it will certainly prevent some Home Loans from -being classified as Covered Home Loans.

B. Prohibitions

As described, the Act provides for the greatest amount of regulation for High Cost Home Loans based upon the valid assumption that those loans are the most likely to invite predatory practices. The Act also prohibits loan flipping for Covered Home Loans (and the included

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[163] Generally considered the average national mortgage rate, it is specifically defined by the Act as "the most recently published annual yield on conventional mortgages published by" the Federal Reserve Board. N.J. STAT. ANN. 46:10B-24(3) ("Conventional Mortgage Rate") (2003). For example, at around the time of the Act's passage, the conventional mortgage rate was 4.88%. *See* note **__** [determining conventional mortgage rate above]

[164] N.J. STAT. ANN. 46:10B-24(3) ("Bona Fide Discount Points") (2003). The Act considers discount points to be recouped within the first five years if "the reduction in the interest rate that is achieved by the payment of the loan discount points reduces the interest charged on the scheduled payments such that the borrower's dollar amount of savings in interest over the first five years is equal to or exceeds the dollar amount of loan discount points paid by the borrower." *Id.* Note, however, that this does not necessarily amount to an actual savings by the borrower because it fails to account for the time value of money.

[165] It will certainly not be surprising, however, to see the subprime market develop low interest, high fee mortgage products as they adapt to the requirements of the Act.

category of High Cost Home Loans), and certain additional economically unjustifiable practices for all Home Loans.

1. High-Cost Home Loans

While many of the following loan terms that are prohibited by the Act may have legitimate economic justification when employed in commercial or prime residential credit markets, the legislature appears to have taken the position that such terms are overwhelmingly predatory in the High Cost Home Loan market.

a) Balloon Payments

Typically, a balloon payment appears as a very large lump-sum payment that is due at the end of the term of a loan that has a schedule of periodic payments.[166] The Act defines a balloon payment more expansively as any "scheduled payment that is more than twice as large as the average of earlier scheduled payments."[167] Lenders claim balloon loans allow borrowers to obtain loans at lower monthly costs in anticipation of increased income or future refinancing at lower rates.[168] If the income increase does not occur and interest rates do not drop, however, the borrower owes an enormous final payment that she often cannot pay. In any event, the legislature seems to have taken the position that most balloon payments for subprime borrowers are predatory because it would be unlikely that the borrower could make the balloon payment and may then be forced to refinance with the same creditor on disadvantageous terms.

b) Negative Amortization

The Act prohibits High Cost Home Loans in which "the outstanding principal balance will increase at any time over the course of the loan because the regular periodic payments do not cover the full amount of interest due."[169] Such a prohibition obviously bars those loans that are intended from the outset to be negative amortization loans. But it also bars adjustable rate loans with capped monthly payments, even where rising interest rates would require higher monthly payments to ensure that the principal balance of the loan did not increase over time. As with balloon loans, lenders claim that negative amortization loans allow borrowers to obtain loans at lower monthly costs in anticipation of increased income or future refinancing at lower rates.[170] Again, the

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166 *See* text accompanying *infra* note __.

167 N.J. STAT. ANN. 46:10B-26(4)(a) (2003). This provision does not apply "when the payment schedule is adjusted to the seasonal or irregular income of the borrower." Id.

168 Fannie Mae, *Taking the Mystery Out of Your Mortgage: What Desktop Underwriter Analyzes in Your Loan Application* (2003) at 25.

169 N.J. STAT. ANN. 46:10B-26(5)(b) (2003).

170 Fair Housing Administration, *FHA Insured Loans, Calculating Graduated Payment Mortgages*, at http://www.hud.gov/offices/hsg/sfh/gpm/gpm_calc.cfm (last checked September 2, 2003).

legislature seems to have taken the position that most negative amortization loans are predatory in the High Cost Home Loan arena.

c) Default Interest Rates

The Act bars the inclusion of provisions in High Cost Home Loans that allow the creditor to increase the interest rate on the loan after a borrower's default.[171] Lenders argue that such default interest rates encourage timely payment as the threat of higher interest rates will encourage borrowers to make their payments. The legislature appears to have agreed with consumer advocates who have argued that such provisions make it impossible to cure a default once it has occurred and thus unnecessarily increases the risk of default and, ultimately, foreclosure.[172]

d) Prepaid Finance Charges

Prepaid finance charges generally refer to "any finance charge paid separately in cash or check before or at consummation of a transaction, or withheld from the proceeds of the credit at any time."[173] Prepayment provisions in the prime market are commonly employed to collect the interest due for the days from closing to the first scheduled monthly payment, which typically would not exceed the first thirty days' interest due on the loan.[174] The Act limits prepaid interest provisions in High Cost Home Loans by prohibiting creditors from retaining at closing any more than two periodic payments – for example, two months' payments on a loan that is repaid on a monthly basis -- from the borrower's loan proceeds.[175]

e) Access to Legal Remedies

The Act voids any provision in a High Cost Home Loan that either: (i) allows a party (such as the creditor) to require a borrower to assert any claim or defense in a forum that is less convenient, more costly, or more dilatory for the resolution of a dispute than the New Jersey courts or (ii) limits in any way any claim or defense the borrower may have.[176] Moreover, a creditor making a High Cost Home Loan must use New Jersey foreclosure procedures.[177]

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[171] N.J. STAT. ANN. 46:10B-26(5)(c) (2003). This provision does not "apply to interest rate changes in a variable rate loan otherwise consistent with the provisions of the loan documents, provided the change in the interest rate is not triggered by the event of default or the acceleration of the indebtedness." Id.

[172] TRUTH IN LENDING, 2002 Supplement, *supra* note __ at §10.4.3.

[173] 12 C.F.R. § 226.2(a)(23) (2003); Regulation Z Official Staff Commentary § 226(a)(23)-2.

[174] Mortgage Terms Dictionary, at http://mortgage-calculators.org/dictionary/dictionary.php3?lit=p.

[175] N.J. STAT. ANN. 46:10B-26(5)(d) (2003).

[176] N.J. STAT. ANN. 46:10B-26(5)(e) (2003).

[177] N.J. STAT. ANN. 46:10B-26(5)(k) (2003). It is unclear whether the legislative intent of this section is to bar mandatory arbitration clauses. Other state predatory lending legislation does bar such clauses, but it is not clear whether arbitration is "less

f) Mandatory Notice to Borrower

In addition to restrictions on creditor activities, the Act attempts to increase consumer understanding of the lending process. The Act requires that creditors making High Cost Home Loans provide a notice to the borrower, at least three days prior to the loan closing,[178] that, among other things, encourages the borrower to consult an attorney and "shop around" for the best deal on their loan.[179] In addition, the notice

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convenient, more costly, or more dilatory" than the court system. *See, e.g.,* N.C. Stat. § 24-1.1(e) (2003).

[178] The Act incorporates the disclosure timing requirements of HOEPA contained in 12 C.F.R. § 226.31(c) (2003).

[179] N.J. STAT. ANN. 46:10B-26(5)(f) (2003). The Act requires that the text of the notice be substantially in the following form:

NOTICE TO BORROWER

YOU SHOULD BE AWARE THAT YOU MIGHT BE ABLE TO OBTAIN A LOAN AT A LOWER COST. YOU SHOULD SHOP AROUND AND COMPARE LOAN RATES AND FEES. MORTGAGE LOAN RATES AND CLOSING COSTS AND FEES VARY BASED ON MANY FACTORS, INCLUDING YOUR PARTICULAR CREDIT AND FINANCIAL CIRCUMSTANCES, YOUR EMPLOYMENT HISTORY, THE LOAN-TO-VALUE REQUESTED AND THE TYPE OF PROPERTY THAT WILL SECURE YOUR LOAN. THE LOAN RATE AND FEES COULD ALSO VARY BASED ON WHICH CREDITOR OR BROKER YOU SELECT.

IF YOU ACCEPT THE TERMS OF THIS LOAN, THE CREDITOR WILL HAVE A MORTGAGE LIEN ON YOUR HOME. YOU COULD LOSE YOUR HOME AND ANY MONEY YOU PUT INTO IT IF YOU DO NOT MEET YOUR PAYMENT OBLIGATIONS UNDER THE LOAN.

YOU SHOULD CONSULT AN ATTORNEY-AT-LAW AND A QUALIFIED INDEPENDENT CREDIT COUNSELOR OR OTHER EXPERIENCED FINANCIAL ADVISOR REGARDING THE RATE, FEES AND PROVISIONS OF THIS MORTGAGE LOAN BEFORE YOU PROCEED. A LIST OF QUALIFIED COUNSELORS IS AVAILABLE BY CONTACTING THE NEW JERSEY DEPARTMENT OF BANKING AND INSURANCE.

YOU ARE NOT REQUIRED TO COMPLETE THIS LOAN AGREEMENT MERELY BECAUSE YOU HAVE RECEIVED THIS DISCLOSURE OR HAVE SIGNED A LOAN APPLICATION.

REMEMBER, PROPERTY TAXES AND HOMEOWNER'S INSURANCE ARE YOUR RESPONSIBILITY. NOT ALL CREDITORS PROVIDE ESCROW SERVICES FOR THESE PAYMENTS. YOU SHOULD ASK YOUR CREDITOR ABOUT THESE SERVICES.

must warn the borrower that (i) by accepting the loan, the creditor will have a mortgage on her home and (ii) failure to make timely payments can lead to the loss of the borrower's home.[180] HOSA's required disclosures are an important supplement to current federal home mortgagor protections both because the disclosures are more comprehensible and comprehensive than those required by TILA and because they are coupled, unlike as in TILA, with actual prohibitions on predatory behavior.

g) Mandatory Loan Counseling

Recognizing that many High Cost Home Loan borrowers are financially unsophisticated and unfamiliar with fundamental aspects of the consumer credit market, the Act attempts to channel prospective High Cost Home Loan borrowers who finance points and fees[181] through independent non-profit loan counselors.[182] Prior to consummating the loan, the creditor must obtain a certification that the borrower has received such counseling (or has completed some other substantial requirement) as to the advisability of the transaction.[183] New Jersey currently has a number of established not-for-profits, such as Citizen Action, which provide such loan counseling.[184]

It is worth noting that by limiting required loan counseling to those whose High Cost Home Loans have financed points and fees – but not to say, High Cost Home Loans that simply have a very high APR – the Legislature appears to offer the benefits of counseling only to those borrowers whose loans contain costs that are less transparent to borrowers. Other High Cost Home Loan borrowers, however, would appear to also benefit from loan counseling, such as borrowers who are eligible for prime loans but who are about to enter into a High Cost Home Loan due to a lack of information about the consumer credit market.

> ALSO, YOUR PAYMENTS ON EXISTING DEBTS CONTRIBUTE TO YOUR CREDIT RATINGS. YOU SHOULD NOT ACCEPT ANY ADVICE TO IGNORE YOUR REGULAR PAYMENTS TO YOUR EXISTING CREDITORS.

[180] N.J. STAT. ANN. 46:10B-26(5)(f) (2003).

[181] Note that a High Cost Home Loan can finance at most two points. N.J. STAT. ANN. 46:10B-26(5)(l) (2003).

[182] N.J. STAT. ANN. 46:10B-26(5)(g) (2003). Such counseling must be given by a "third-party nonprofit credit counselor, approved by the United States Department of Housing and Urban Development and the Department of Banking and Insurance" regarding the "advisability of the loan transaction . . .." *Id.*

[183] N.J. STAT. ANN. 46:10B-26(5)(g) (2003).

[184] *See, e.g.*, Citizen Action Homepage, at http://www.njcitizenaction.org/ (last checked August 29, 2003).

h) Direct Payment to Home Improvement Contractors

Home improvement contractors frequently help generate predatory loans. In many cases, an unscrupulous contractor will arrange financing for a home improvement loan with a pre-selected predatory lender, so as to be paid directly by the complicit lender at loan closing before the work is complete or capably done.[185] Such a direct payment arrangement deprives a borrower of any leverage to control the quality or timeliness of a contractor's work. In response to this prevalent practice, the Act prohibits any of the proceeds from a High Cost Home Loan from being paid directly to a home improvement contractor.[186]

i) Loan Modification and Deferral Fees

A creditor shall not charge a borrower any fees to modify, renew, extend, or amend a High Cost Home Loan or to defer any payment due under the terms of a High Cost Home Loan.[187] This provision, while facially similar to provisions limiting the costs of refinancing, appears to address changes to the non-monetary terms of a loan as well as unplanned contingencies that affect a borrower's ability to make scheduled loan payments.[188]

For instance, if a creditor and borrower agree to any change in the terms of the High Cost Home Loan – as where a borrower wants to defer a few monthly payments during a period of unemployment – the creditor simply cannot charge any fees.[189] It is unclear why the Legislature chose to categorically prohibit charges for such modifications – which would appear to dramatically reduce creditor incentive to agree to loan modifications – when some could be useful to a borrower if made available on reasonable terms.[190]

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185 *See* text accompanying *infra* notes __ to __.

186 N.J. STAT. ANN. 46:10B-26(5)(h) (2003). The proceeds of a home-improvement loan must be payable (i) to the borrower, (ii) jointly to the borrower and the contractor or (iii) at the election of the borrower, to a third-party escrow agent in accordance with a written agreement signed by the borrower, creditor and contractor prior to disbursement. *Id*.

187 N.J. STAT. ANN. 46:10B-26(5)(i) (2003).

188 Renewing a loan is borrowing a similar amount under the same terms as the previous loan after its payment term has expired. Refinancing is "paying off an existing loan with the proceeds from a new loan, usually of the same size, and using the same property as collateral." Investorwords.com, at http://www.kiplinger.com/basics/glossary/#R (ast checked September 2, 2003). Typically, borrowers refinance when they want "to reduce monthly payments or to modify interest charges." *Id.*

189 This prohibition does not prevent the creditor from capitalizing deferred interest. Thus, if a borrower missed a payment, the creditor could add the missed interest to the principal balance due on the loan.

190 *Cf.* N.J. STAT. ANN. 46:10B-26(5)(j) (2003) (limiting refinancing points and fees for High Cost Home Loans to two percent).

j) Same-Creditor Refinancings

The Act prohibits any creditor from flipping Covered Home Loans (which include all High Cost Home Loans) extended by that or any other creditor in certain circumstances.[191] In addition, Section 5(j) of the Act bars a creditor from charging points and fees for a new High Cost Home Loan that refinances an existing High Cost Home Loan already owned by that same creditor.[192] This additional prohibition seems to acknowledge that a creditor that refinances a loan that it already owns faces lower underwriting costs than a new creditor because it already has at least some underwriting data on and a payment history with that borrower.[193]

k) Limited Financings of Points and Fees

Under no circumstances may a creditor finance, directly or indirectly, points and fees for a High Cost Home Loan that are in excess of two percent of the total loan amount.[194] This section, of course, does not bar the charging of more than two points to be paid in cash, but recognizes that the financing of points and fees represents a hidden cost to many subprime borrowers and frequently has the effect of stripping equity from their homes.[195] This two point cap does allow cash-poor borrowers (e.g., those who do not have the cash to pay points and fees up front) to access the equity in their homes, but limits those points and fees to an amount that is more in line with those found in the prime market than in the high end of the subprime market.[196]

2. Covered Home Loans

As described, the Act's intermediate classification of loans, Covered Home Loans, have a lower points and fees trigger than High Cost Home Loans and therefore includes a greater number of Home Loans within its regulatory scope.[197] Covered Home Loans (which includes all High Cost Home Loans) have only one prohibition in addition to those that apply to all Home Loans. This prohibition relates to the practice of "flipping" loans.[198] Flipping generally refers to the practice of creditors repeatedly refinancing loans primarily as a way of

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191 *See* text accompanying *infra* notes __ - __.

192 N.J. STAT. ANN. 46:10B-26(5)(j) (2003).

193 Where the originating creditor still holds the note, this assumption would seem to be particularly valid as it could rely in part on its initial underwriting analysis. This assumption might be less strong where the borrower seeks the refinancing from a creditor who purchased the loan on the secondary market. Nonetheless, this provision applies to the secondary market purchaser as much as it does to the originator.

194 N.J. STAT. ANN. 46:10B-26(5)(l) (2003).

195 See text accompanying note __.

196 *See* text accompanying note __(where they are charged, points and fees in prime market average __%).

197 *See* text accompanying *supra* notes __ to __.

198 N.J. STAT. ANN. 46:10B-25(4)(b) (2003).

extracting prepayment penalties, points and other costs.[199] By prohibiting flipping in a broader segment of the residential mortgage market, the legislature appears to have concluded that flipping is a particularly abusive practice that inequitably strips equity from borrowers throughout a greater portion of the subprime market than just the High Cost Home Loan portion.

According to the Act, flipping occurs when: (i) a creditor makes a Covered Home Loan to a borrower; (ii) that refinances any existing home loan[200] that was consummated within the prior 60 months; and (iii) that new loan does not have a "reasonable, tangible net benefit to the borrower."[201] The only elaboration offered by the Act to assess whether a loan provides such a benefit is to consider "all the circumstances, including the terms of both the new and refinanced loans, the economic and noneconomic circumstances."[202] In response to industry concerns about the ambiguity of the "reasonable tangible net benefit" standard, the New Jersey Department of Banking and Insurance ("DOBI") issued guidelines to assist lenders and presumably, courts interpreting the Act.[203]

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199 *See* text accompanying *supra* notes __ to __.

200 The Act specifically addresses whether a loan that was closed prior to the Act's effective date of November 27, 2003 is deemed to be an existing home loan for the purposes of the Act's flipping provisions. The Act deems such a loan an "existing home loan" so long as it meets the Act's definition of a Home Loan. N.J. STAT. ANN. 46:10B-35(15) (2003).

201 N.J. STAT. ANN. 46:10B-25(4)(b).

202 N.J. STAT. ANN. 46:10B-25(4)(b) (2003).

203 According to DOBI, "lenders should look at a range of factors related to an individual borrower's

circumstances." State of New Jersey Dep't of Banking and Insurance Bulletin No. 03-15, July 25, 2003, at 10. DOBI provides the following examples of factors that could be relevant to the reasonable tangible net benefit assessment:

- Terms of the new and old loan, including, but not limited to, note rate, amortization schedule, and balloon payment provisions, provided that costs associated with (and paid at or before closing of) the old loan, such as closing costs or points and fees other than prepayment penalties, are not normally relevant to the determination of flipping;
- Costs of the new loan, including points and fees charged on the new loan as well as other closing costs associated with the transaction as routinely disclosed on the closing statement;
- Loan-to-value ratio of the new loan compared to that associated with the outstanding balance on the existing home loan;
- Debt-to-income ratio of the borrower before and after the proposed transaction;
- In cases where economic benefits do not demonstrably indicate that a reasonable, tangible net benefit has occurred, a

In addition, the Act specifies two additional circumstances in which any "home loan refinancing" is presumed to constitute illegal flipping: (1) where the primary tangible benefit to the borrower is a lower interest rate on the "new loan" and where it will take more than four years for the borrower to recoup her closing costs through the interest rate savings; and (2) where the borrower will lose the benefits of a mortgage originated, subsidized or guaranteed by or through a state, tribal or local government, or nonprofit organization and where that mortgage had either (i) a below-market interest rate at the time of origination or (ii) beneficial non-standard payment terms such as payments that vary with income or are limited to a percentage of income or where no payments are required in certain circumstances.[204]

It appears from the plain language of these two additional types of flipping that they apply even if the new loan is merely a Home Loan and not a Covered Home Loan: in describing these additional circumstances, it refers to a "home loan refinancing" and a "new loan" with no mention that the new loan be a Covered Home Loan. This plain text reading of the Act would not be controversial other than for the fact that DOBI has taken the position that the Act only applies where the new loan is a Covered Home Loan.[205] DOBI's analysis, however, is inconsistent with the text of the Act. The result of the textual reading of the Act is that all Home Loan refinancings must be reviewed to ensure that they do not fall within this broad definition of flipping.

3. All Home Loans[206]

The following are practices that are prohibited for all Home Loans – including Covered Home Loans and High Cost Home Loans.

a) Credit Insurance

HOSA prohibits creditors from financing any credit insurance along with all Home Loans.[207] For the reasons already described, the packing of financed credit insurance premiums has become a huge financial boon to certain lenders without providing any reasonable benefit to – and, indeed, stripping substantial equity from – the

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significant reason that explains the need for, and proposed use of, the loan proceeds; and

- Other benefits the borrower receives from the transaction.

Id. In addition, DOBI recommends that the lender "obtain an explanation from the borrower regarding any non-economic benefits the borrower associates with the loan transaction. *Id.*

[204] N.J. STAT. ANN. 46:10B-25(4)(b)(1)-(2) (2003).

[205] Bulletin at 10.

[206] This includes, as mentioned above, all Covered Home Loans and High Cost Home Loans.

[207] N.J. STAT. ANN. 46:10B-25(4)(a) (2003). As previously described this provision of the Act renders Section 24(3), requiring the inclusion of the cost of financed credit insurance as part of the points and fees calculation. *See supra* note __.

borrowers who are frequently deceived into accepting such insurance.[208] The legislature apparently regarded the practice of financing credit insurance as so valueless, that they chose to prohibit it for all categories of Home Loans. Borrowers can still elect credit insurance in which premiums are paid on a monthly installment basis, as long as those premiums are not financed into the loan amount.[209]

b) Encouraging Default

The Act prohibits creditors from encouraging default on existing debt through refinancing a Home Loan.[210] When a prospective creditor encourages default, it unnecessarily puts the borrower at risk of foreclosure and destroys her credit rating. This can easily make the borrower utterly dependent upon such creditor even if the terms being offered are severely disadvantageous given the borrower's credit profile. The legislature recognized that this practice is so universally coercive and without legitimate economic that it banned the practice for all Home Loans.

c) Late Payment Fees

The Act also regulates late payment fees that creditors can charge in relation to all Home Loans in the following ways: (i) No late payment fee may be in excess of five percent of the amount of the payment past due;[211] (ii) late fee payments may only be assessed for a payment past due for fifteen days or more;[212] (iii) late fee payments cannot be charged more than once for the same late payment;[213] (iv) no late fee payment may be imposed unless the creditor notifies the borrower within forty-five days following the date the payment was due that a late payment fee had been imposed for a particular late payment;[214] (v) the creditor shall

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208 *See* text accompanying *supra* notes __ to __.

209 N.J. STAT. ANN. 46:10B-25(4)(a) (2003).

210 N.J. STAT. ANN. 46:10B-25(4)(c) (2003).

211 N.J. STAT. ANN. 46:10B-25(4)(d)(1) (2003).

212 N.J. STAT. ANN. 46:10B-25(4)(d)(2) (2003).

213 N.J. STAT. ANN. 46:10B-25(4)(d)(3) (2003). If a late payment fee is deducted from a payment made on the loan, and such deduction causes a subsequent default on a subsequent payment, no late payment fee may be imposed for such default. If a late payment fee has been once imposed with respect to a particular late payment, no such fee shall be imposed with respect to any future payment that would have been timely and sufficient, but for the previous default. *Id*.

For example, a borrower owes a $1000 monthly payment to a creditor due on the first of each month. In April, the borrower pays $1000 on April 20 and misses the assigned due date by more than 15 days. The creditor assesses a $50.00 late payment fee for April. In May, the borrower pays $1000 on May 1st. The creditor cannot take $50.00 from the May payment, apply it to April's late fee, and assess another late payment fee of $50.00 because the borrower paid only $950.00 toward May's balance. Instead, and in effect, the borrower cannot pay off the entire loan until that $50 is also paid off, but otherwise the failure to pay the late payment fee will have no effect on the borrower.

214 N.J. STAT. ANN. 46:10B-25(4)(d)(4) (2003). No late payment fee may be collected from any borrower if the borrower informs the creditor that nonpayment of an

treat each and every payment as posted on the same date as it was received by the creditor, servicer, creditor's agent, or at the address provided to the borrower for making payments.[215]

d) Discretionary Loan Acceleration

Acceleration provisions are common in loan documents to allow a lender to demand payment of the total outstanding balance or demand additional collateral before the end of the term of the loan, upon material default by the borrower. HOSA bans the utterly commercially unreasonable practice of accelerating a loan in the lender's sole discretion.[216] The Act plainly recognizes that a borrower should be able to rely upon a contractual payment schedule and not be subject to foreclosure upon a lender's whim.

e) Payoff Letter

Where a borrower seeks information on a loan's remaining payoff balance, the creditor must provide it within seven business days of the borrower's request free of charge.[217] This curbs the excessive fees that some lenders have taken to charging for such a simple request.

4. What HOSA Fails to Regulate

HOSA is also notable for its failure to directly regulate two very common features of predatory loans previously described. First, HOSA, unlike HOEPA, does not address the predatory practice of asset-based lending by in any way requiring lenders to consider a borrowers' ability to repay a High Cost Home Loan.[218] HOEPA currently prohibits lenders from extending credit without regard to a borrower's ability to repay[219] but only in cases where the lender engages in a "pattern or practice" of such activity.[220] A requirement that a lender consider a borrower's

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installment is in dispute and presents proof of payment within 45 days of receipt of the creditor's notice of the late fee. From the text, it appears that the mere assertion of a dispute is sufficient for the borrower to avoid a late fee so long as the borrower makes the late payment in the time proscribed by the statute.

[215] N.J. STAT. ANN. 46:10B-25(4)(d)(5) (2003). It appears that the creditor must post a payment as received even if it sent to any address of the creditor, servicer or the creditor's agent other than the one indicated for the making of payments. This seems odd.

[216] N.J. STAT. ANN. 46:10B-25(4)(e) (2003). This provision does not prohibit acceleration of the loan in good faith due to the borrower's failure to abide by the material terms of the loan. Id.

[217] N.J. STAT. ANN. 46:10B-25(4)(f) (2003).

[218] *See* text accompanying *infra* notes __ to __ (describing lending without ability to repay as central component of many predatory loans).

[219] HOEPA defines this conduct as extending credit "based on the consumer's collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment." 15 U.S.C. § 1639(h).

[220] Traditionally, the pattern or practice element of the prohibition has been a hard one for plaintiffs to satisfy, requiring proof of several instances of prohibited conduct in short period of time. *Newton v. United Companies Financial Corp.*, 24 F. Supp. 2d 444, 457 (E.D. Pa. 1998). The recent amendments have loosened the requirement

ability to repay based on her income rather than the equity in their home, akin to provisions of a number of states addressing predatory lending,[221] would have been an important supplement to HOEPA's limited protections for New Jersey Home Loan borrowers.

Second, the Act does not directly regulate the common predatory practice of levying prepayment penalties on High Cost Home Loans.[222] Virtually all of the states that have chosen to aggressively respond to the problem of predatory lending have either banned or substantially limited prepayment penalties that can be charged with High Cost Home Loans,[223] and HOEPA bans the practice under certain circumstances.[224] Although High Cost Home Loan borrowers in New Jersey may have benefited from a direct limitation on prepayment penalties, perhaps in the form of a prohibition on such fees after a period of years from origination had elapsed, HOSA does indirectly regulate impositions of such penalties. If prepayment penalties are to be assessed against a High Cost Home Loan, they cannot be imposed by a creditor refinancing a loan already held by that creditor.[225]

C. Liability Under The Act

The liability provisions of the Act are somewhat complex but allow for substantial damages against creditors who violate them.

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somewhat, creating a presumptive violation where the lender has failed to document and verify the borrower's ability to pay. The amended rule seeks to strengthen HOEPA's prohibition on making loans based on homeowners' equity without regard to repayment ability. It "creates a presumption that a creditor has violated the statutory prohibition on engaging in a pattern or practice of making HOEPA loans without regard to repayment ability if the creditor generally does not verify and document consumers' repayment ability." 66 Fed. Reg. 65604, 65606 (Dec. 21, 2001).

221 *See, e.g.*, N.C. GEN. STAT. §§24-1.1E (7)(c)(2) (prohibiting lending without considering borrower's ability to repay, but presuming such ability exists if monthly debt-to-income ratio is 50 percent or lower); MASS. REGS CODE TIT. 209 § 32.00 (5)(a) (same); CAL. FIN. § 4931(f)(1) (same prohibition but setting ratio at 55%); 2003 ARK. ACTS § 2598(k)(1) (requiring lenders to evaluate borrower's ability to repay but setting no percentage of debt-to-income ratio that would presumptively establish such ability).

222 *See* text accompanying *infra* notes __ to __ (discussing ways in which prepayment penalties can be abusive when made in connection with high cost loans).

223 *See, e.g.*, 2003 ARK. ACTS (3)(m) (prohibiting financing of prepayment fees or penalties); CAL FIN. § 4970(a)(1) (limiting or barring prepayment fees depending proximity to closing date); 1 GA. CODE ANN. § 7-6A-5 (1)(A)(B) (limiting or barring prepayment fees depending on proximity to closing date); N.C. GEN. STAT. § 24-1.1E (c)(3)(a) (prohibiting all prepayment penalties).

224 Specifically, HOEPA prohibits the imposition of prepayment penalties unless the creditor can demonstrate that: (1) the loan will not cause the borrower to pay more than 50% of gross monthly income toward "monthly indebtedness payments"; (2) the borrower's income and expense are verified by a financial statement signed by the borrower and by a credit report; (3) the creditor is not refinancing either it's own or an affiliate's loan; (4) it is imposed only during the first five years of the law; (5) the prepayment penalty is otherwise legal under state law. *See* 15 U.S.C.A. § 1639(c)(2)(a)-(d).

225 *See* text accompanying *supra* notes __ to __ (discussing prohibition contained in N.J. STAT. ANN. 10B-

Notably, New Jersey is now one of only a handful of states that has extended liability broadly to assignees of certain Home Loans. [226] Indeed, the scope of the Act's assignee liability provisions are broad enough to alter the dynamic of secondary market financing of High Cost Home Loans. As a result, the Act's assignee liability provisions are likely to dry up much of the funding for predatory loans in New Jersey.

1. Creditor Liability

Section 8 of the Act provides for both damages and equitable relief against creditors who violate the Act's provisions. First, a violation of the Act is deemed a *per se* violation of the New Jersey Consumer Fraud Act.[227] Accordingly, a borrower may elect to seek damages under *either,* but not both: (i) the Consumer Fraud Act, which mandates treble damages – itself a strong remedy – and attorneys fees,[228] or: (ii) the Act, which provides for statutory damages for material violations equal to all finance charges agreed to in the Home Loan agreement, plus up to 10% of the amount financed.[229] In addition to this election, a borrower may be entitled to recover punitive damages for egregious violations, costs and reasonable attorneys' fees.[230] The structure of this damages election, which requires borrowers to choose between the Consumer Fraud Act's treble damages provision or the Act's statutory damages and then authorizes punitive damages on top of this election, gives the Act one of the strongest consumer protection remedies in New Jersey.

Second, the Act authorizes broad equitable relief.[231] Thus, borrowers may, in addition to seeking damages, assert violations of the Act as a defense to a creditor's foreclosure. Where creditors commit material violations, borrowers may thereby be entitled to extinguish their entire obligation under the predatory loan.[232]

[226] *See, e.g.,* 2003 N.M. Laws Ch. 436; 2001 N.Y. Laws 11856.

[227] N.J. STAT. ANN. 46:10B-29(8)(a) (2003).

[228] N.J. STAT. ANN. 56:8-19 (in a Consumer Fraud Act action "the court shall, in addition to any other appropriate legal or equitable relief, award threefold the damages sustained by any person in interest. In all actions under this section, including those brought by the Attorney General, the court shall also award reasonable attorneys' fees, filing fees and reasonable costs of suit.").

[229] N.J. STAT. ANN. 46:10B-29(8)(a), (b)(1) (2003).

[230] N.J. STAT. ANN. 46:10B-29(8)(b)(1)(b)-(c) (2003). Importantly, the Act expressly states that its penalty provisions are cumulative, not exclusive of, other remedies a borrower may have. N.J. STAT. ANN. 46:10B-30 (2003). Borrowers may therefore still assert causes of action under TILA, HOEPA, the Real Estate Settlement Procedures, Act, common law fraud and unconscionability doctrines and the like.

[231] N.J. STAT. ANN. 46:10B-29(8)(b)(2) (2003).

[232] The Act also contains a catch-all and somewhat ambiguous provision that makes it a violation of the act to, in bad faith, circumvent the application of the Act by either (i) dividing a loan transaction into separate parts or (ii) using any other subterfuge with the intent to evade the Act. N.J. STAT. ANN. 46:10B-27(6)(c) (2003). The catch-all provision appears to reflect the legislature's concern that it has not anticipated every possible method of engaging in abusive lending practices. *Cf*. Eric

However, there appear to be two provisions of the Act that may impose caps on damages that are inconsistent with this general creditor liability provision and that are made all the more peculiar because of their placement in unrelated sections of the Act. First, Section 6(a) of the Act, which predominantly deals with assignee liability considerations, imposes a damages cap of (i) the amount already paid on the loan, (ii) remaining liability, plus (iii) costs and attorney's fees, for actions against manufactured home loan and home improvement loan creditors who have worked in tandem on the borrower's loan with the seller of the manufactured home or home improvements ("Sales and Services Creditors").[233] Perhaps the best way of reconciling this apparent inconsistency is to construe the specific Section 6(a) provision as a cap on damages only as against the narrow category Sales and Services Creditors. Borrowers would be entitled to pursue the broader range of damages under Section 8 against all other creditors.[234]

Second, Section 6(c) appears to impose a damages cap for Covered Home Loans and High Cost Home Loans that is inconsistent with the Act's general liability provisions. Section 6(c) limits damages against a Covered Home Loan or a High Cost Home Loan creditor, along with the assignees of such a loan, to (i) a borrower's remaining obligation under the loan plus (ii) costs and attorney's fees.[235] While this additionalreference to creditor liability, in a section of the Act that deals primarily with assignee liability, may be a drafting error, the plain language appears to impose a cap on damages against Covered Home Loan and High Cost Home Loan creditors that is typically less than the damages provided for in the general liability section of the Act. Perhaps the best way to make sense at least of the High Cost Home Loan damages cap in Section 6(c) is to read that section as a damages cap that applies when actions are brought after the Act's default six-year statute of limitations period. There appears to be no comparable way to make sense of the apparent Covered Home Loan; however, one could read the apparently inconsistent provisions as offering borrowers a choice to sue

Posner and Richard Haynes, *The Law and Economics of Consumer Finance*, 4 AM. LAW AND ECON. REV. 162 (2003) (arguing that much consumer protection legislation is rendered ineffective by their targets' ability to circumvent black letter prohibitions). The provision appears to be directed against secondary market players, *see*, N.J. STAT. ANN. 10B-27(6)(e) (2003), so it is likely that this provision of the Act is intended to prevent the secondary market from structuring residential mortgage backed securities pools so that they separate the flow of income from New Jersey Home Loans from the potential liability that might accrue from such loans that violate the Act.

[233] N.J. STAT. ANN. 10B-27(6)(a) (2003).

[234] An alternative reading would authorize borrowers to choose to sue the subcategory of Sales and Services Creditors for damages under either the Consumer Fraud Act, Section 8(b)'s statutory damages provisions, or Section 6(a)'s recoupment provision, whichever is the greater.

[235] N.J. STAT. ANN. 10B-27(6)(c) (2003).

under the provision that awards the greater damages or even as offering borrowers cumulative remedies.[236]

2. Assignee Liability

The Act includes an express assignee liability provision in order to partially abrogate the scope of the holder-in-due-course doctrine, and thereby increase the reach of the Act's remedies and defenses. As previously described, the holder-in-due-course doctrine frequently imposes a substantial impediment to borrowers who seek redress for their predatory loans because it shields good faith purchasers and assignees of those loans from liability for even the most outrageous conduct by the originating creditors.[237] Because many predatory lenders depend for their financing on the securitization of their mortgage pools and subsequent sale on the secondary markets,[238] the Act's assignee liability provisions are meant to dry up resources available to originators of those loans that violate the Act. The assignee liability provisions, like the Act's prohibitions themselves, depend upon how the loan is classified.

a) High Cost Home Loans

Two provisions regulate assignee liability for High Cost Home Loans. Each of these provisions is governed by a different statute of limitations. The first provision allows a borrower to assert any and all affirmative claims for damages – including the damages election described above – or defenses that she may have against the original High Cost Home Loan creditor.[239] As such, this assignee liability provision is a complete abrogation of the holder in due course doctrine for High Cost Home Loans. A borrower of a High Cost Home Loan can, therefore assert any affirmative claim for damages available under Section 8 of the Act, including damages under the Consumer Fraud Act or statutory damages, as well as any available claims or defenses, including strong defenses to foreclosure, equally against *both* the creditor *and* the subsequent purchaser.

While this abrogation of the holder-in-due-course doctrine is sweeping, the Act does provide certain safe harbors for those assignees that did not intend to invest in High Cost Home Loans, if the purchaser or assignee can demonstrate that, employing "reasonable due diligence,"

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236 In other words, this reading might allow a borrower in certain circumstances to sue for the Consumer Fraud Act and statutory damages election provided for in Section 8(a) *and* the applicable Section 6 provision. *See* Standard & Poor's, *Standard & Poor's Addresses new Jersey Predatory Lending Law*, May 2, 2003, available at www.standardandpoors.com.

237 *See* text accompanying *supra* notes __ to __.

238 *See* text accompanying *supra* notes __ to __.

239 N.J. STAT. ANN. 46:10B-27(6)(b) (2003) (purchaser or assignee of a High-Cost Home Loan is "subject to all affirmative claims and any defenses with respect to the loan that the borrower could assert against the original creditor or broker of the loan . . ..").

it could not have determined that the purchased loan was a High Cost Home Loan."[240] These safe harbors provide a variety of simple and low-cost ways for assignees and purchasers to preserve traditional holder-in-due-course defenses for High Cost Home Loans that they inadvertently purchase. But for those who fail to comply with the safe harbor provisions or who intend to invest in High Cost Home Loans, the Act does abrogate the holder-in-due-course rule and subjects them to all claims and defenses available against creditors. In order to avoid liability, therefore, the secondary market will either attempt to stop purchasing High Cost Home Loans altogether by complying with the safe harbor provision or undertake the due diligence required to purchase only those High Cost Home Loans that do not violate any of the Act's provisions.

The second assignee liability provision applies even where an assignee meets the criteria entitling it to the protections of the Act's safe harbor provisions, but limits potential damages. Specifically, damages against all holders of High Cost Home Loans, even those that fall within

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[240] N.J. STAT. ANN. 46:10B-27(6)(b) (2003). The Act sets forth a basis for a purchaser or assignee to be given a presumption that it has exercised such due diligence, if it can demonstrate by a preponderance of the evidence that it:

> (1) has in place at the time of the purchase or assignment of the loan, policies that expressly prohibit its purchase or acceptance of assignment of any high-cost home loan;
>
> (2) requires by contract that a seller or assignor of home loans to the purchaser or assignee represents and warrants to the purchaser or assignee that either
>
> (a) it will not sell or assign any high-cost home loan to the purchaser or assignee or
>
> (b) that the seller or assignor is a beneficiary of a representation and warranty from a previous seller or assignor to that effect; and

(3) exercises reasonable due diligence at the time of purchase or assignment of home loans or within a reasonable period of time thereafter intended by the purchaser or assignee to prevent the purchaser or assignee from purchasing or taking assignment of any High Cost Home Loan.

N.J. STAT. ANN. 46:10B-27(6)(b) (2003). The Act does not specifically define "reasonable due diligence." DOBI has taken the position that reasonable due diligence does not typically require an assignee to review every loan being purchased. Bulletin at 8 ("The Department considered the concept of "reasonable due diligence" as generally understood by courts, which is `what a reasonable person would have done in his situation given the same information.' The Department is in the process of reviewing common banking and secondary market practices regarding due diligence review of mortgage pools, as well as similar due diligence in the securities context, and believes, based on the information it has obtained to date, that sampling is a standard accepted practice.

the assignee safe harbor provision, are limited to the borrower's remaining obligation under the loan plus costs and attorney's fees.[241]

This second assignee liability specifically authorizes such claims to be brought by the borrower at any time during the term of the loan.[242] The Act otherwise specifies no statute of limitations for any other provisions governing High Cost Home Loans. Accordingly, New Jersey's default statute of limitations period for tort actions, would appear to apply to all other High Cost Home Loan actions brought under other sections of the Act.[243]

b) Covered Home Loans

The Act provides for assignee liability for Covered Home Loans, but authorizes less damages than may be available against assignees of High Cost Home Loans . Specifically, Section 6(c) provides that a borrower suing in an individual capacity and within six years of the loan's closing, may assert a violation of the Act against a creditor or any assignee of a Covered Home Loan to recover the remaining obligation under the loan, plus costs and attorney's fees.[244] While it is important to have provided borrowers with a strong defense to foreclosure actions brought by assignees of Covered Home Loans, this liability is extinguished after merely six years.

c) Home Loans

The Act's assignee liability provisions are more limited for Home Loans, applying only to those made in connection with a manufactured home or home improvement contract and offering slightly limited damages. Accordingly, if a Home Loan "was made, arranged, or assigned by a person selling either a manufactured home, or home improvements to the dwelling of a borrower, or was made by or through a creditor to whom the borrower was referred by such seller, the borrower may assert all affirmative claims and any defenses that the borrower may have against the seller or home-improvement contractor . . . ."[245] That is, if either a manufactured home seller or a home improvement contractor is working in tandem with a creditor, the borrower may assert any claims or defenses it has against the former in an action brought against (or brought by) the ultimate holder of the loan.[246]

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241 N.J. STAT. ANN. 46:10B-27(6)(c) (2003).

242 N.J. STAT. ANN. 46:10B-27(6)(c) (2003).

243 N.J. STAT. ANN. 2A:14-2__ (2003)

244 N.J. STAT. ANN. 46:10B-27(6)(c) (2003).

245 N.J. STAT. ANN. 46:10B-27(6)(a) (2003).

246 Although the Act does not address how much involvement a home improvement contractor or manufactured home seller must have in arranging a home loan for N.J. STAT. ANN. 46:10B-27(6)(a) to be apply, DOBI has taken the position that

> The requisite level of involvement will be reached if the contractor or seller is sufficiently involved in making or otherwise participating in

Damages available against creditors, holders or assignees in such cases are limited "to amounts required to reduce or extinguish the borrower's liability under the Home Loan, plus the total amount paid by the borrower in connection with the transaction, plus amounts required to recover costs, including reasonable attorney's fees."[247] While on its face, this limitation would prevent recovery under the Consumer Fraud Act's treble damages provision, damages in the form of the "total amount paid by the borrower" in connection with the loan, plus reasonable attorneys fees could otherwise be substantial.[248]

3. Defenses

Creditors acting in good faith who fail to comply with the Act may escape liability under of the Act if the creditor: (i) within forty-five days of the loan closing, makes restitution to the borrower and appropriately adjusts the loan; or (ii) within 90 days of the loan closing and prior to receiving any notice from the borrower of the compliance failure, notifies and makes restitution to the borrower and appropriately adjusts the loan.[249] The latter defense is available only where the compliance failure was unintentional and resulted from a bona fide error, notwithstanding the maintenance of procedures reasonably adopted to

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> the home loan as consistent with the substantial guidance and precedent that underlies the FTC Holder Rule. For example, the circumstances in which a home improvement contractor will be determined to have "referred" a borrower to a lender under N.J. STAT. ANN. 46:10B-27a, will include "those situations where a [home repair] seller, in the ordinary course of business, is sending his buyers to a particular loan outlet, or to particular outlets, for credit which is to be used in the sellers' establishment. In such circumstances, the seller is effectively arranging credit for his customers."

N.J. Department of Banking and Insurance, Bulletin No. 03-15, at 5-6 (July 25, 2003) (internal citations omitted).

[247] N.J. STAT. ANN. 46:10B-27(6)(a) (2003).

[248] The statute of limitations provisions under the Act appear almost Byzantine. They are best understood by recognizing that HOSA is enacted into the background New Jersey statute of limitations provisions. For all tort violations that do not have an explicit statute of limitations provision, which category includes some HOSA violations, the New Jersey statute of limitations is six years. Cite. Therefore, unless otherwise specified by the Act, all violations under the Act seeking the type of damages described are subject to a six year statute of limitations. However, High Cost Home Loan borrowers asserting causes of action and/or defenses, brought in an individual capacity only, that seek equitable relief in the form of recoupment – an amount "required to reduce or extinguish the borrower's liability under the home loan" – or similar defenses to foreclosure, can assert them at any time.

[249] N.J. STAT. ANN. 46:10B-29(8)(c) (2003). The Act preempts all municipality, county or political subdivision ordinances, resolutions, or any other rules or regulations related to home loan lending practices. N.J. STAT. ANN. 46:10B-34(13) (2003). The lending industry regarded this inclusion of this preemption clause as a significant victory as, they argued, multiple layers of regulation adds to lenders' compliance costs and increases the risk of unintentional statutory violations. *See, e.g.*, MBANJ Backs Compromise, Origination News, April 2003.

avoid such errors.[250] This provision encourages creditors to conduct post-closing due diligence and correct unintentional violations of the Act.

III. EVALUATING THE ACT'S EFFECTIVENESS

Throughout the period of the Act's consideration in the New Jersey legislature and lingering still, are important concerns about the Act's effectiveness. Those concerns, which we identify and comment on here, are first, whether the Act's provisions will have the unintended and harmful consequence of drying out legitimate, desired subprime credit; and second, whether the Act's assignee liability provisions will cause leading bond rating agencies to refuse to rate securitized mortgages and consequently end subprime mortgage financing by the secondary mortgage markets in New Jersey.

A. The Continued Availability Of Subprime Credit In New Jersey

A persistent objection leveled against HOSA and other, similar efforts to regulate high cost loans is that they are ultimately counterproductive – that is, that such regulations will make it both so risky and costly to make high cost loans that most subprime lenders would abandon subprime lending entirely, leaving traditional subprime borrowers without any access to home equity credit.[251] This objection, however, appears to be largely overstated. Based on our understanding of the dynamics of the subprime lending market and the experience of other states, we predict that HOSA will dry up many predatory, high cost loans while leaving an ample supply of subprime credit available for this still lucrative market.[252] Indeed, it may be that the Act does not go far enough: HOSA's high cost loan triggers could have been set even lower to bring in a greater proportion of loans into its regulatory scope without causing material harm to legitimate subprime lending.

First, a central premise of the concern over the Act's possible undermining of legitimate subprime lending – that the higher costs

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[250] N.J. STAT. ANN. 46:10B-29(8)(c) (2003). Examples of bona fide errors include "clerical, calculation, computer malfunction and programming, and printing errors. An error of legal judgment with respect to a person's obligations under this section is not a bona fide error." N.J. STAT. ANN. 46:10B-29(8)(c) (2003).

[251] *See, e.g.,* Kelly K. Spors, *Republican Bill Aims to Mute State Laws on Subprime Loans*, WALL STREET JOURNAL, February 14, 2003, at A4 ("The subprime-lending industry complains that local regulation is confusing and counterproductive. For example, legislation enacted in Georgia makes anyone who winds up owning the loans -- including Fannie Mae and Freddie Mac -- liable for lending violations. As a result, Fannie and Freddie have stopped buying some loans made in Georgia. Standard & Poor's and Moody's Investors Service have said they will no longer rate mortgage-backed securities that include loans covered by the law, and some subprime lenders say they have pulled certain products out of the market there.").

[252] *Cf.* HUD-Treasury Report, supra note __ at 108 ("If the secondary market refuses to purchase loans that carry abusive terms, or loans originated by lenders engaging in abusive practices, the primary market may react to the resulting lack of liquidity by ceasing to make these loans").

associated with making subprime loans under HOSA will make their extension unprofitable – appears flawed. As an initial matter, HOSA's High Cost Home Loan APR trigger – eight percent above the prevailing Treasury rate – is still very high. Nationally, subprime loans have interest rates that average 2.5 - 4% above prime mortgage rates.[253] Thus, HOSA's High Cost Home Loan prohibitions will affect only a relatively small proportion of the subprime lending market and at rates that are already high.[254]

In addition, as we have highlighted elsewhere, studies of the subprime market demonstrate a highly imperfect correlation between a borrower's credit risk and mortgage pricing, which would suggest a significant range of subprime lending profitability at rates below HOSA's High Cost Home Loan triggers.[255] Underwriting standards among different subprime lenders vary greatly, as do underwriting standards within a particular lending entity over time.[256] In part as a result, and very much unlike the prime market, the range of pricing of subprime loans varies so greatly – between 3% and 19.99% in 1999 according to one study[257] – that subprime lending rates cannot consistently or accurately account for legitimate credit risk variations and very likely reflect a strong bias toward overpricing.[258]

Indeed, studies by both Government Sponsored Entities and the subprime industry itself, demonstrate that a substantial proportion of subprime borrowers are currently highly overcharged for their mortgages. The Chairman of Fannie Mae estimated in 2000 that approximately fifty percent of all subprime borrowers could have qualified for a lower cost, prime loan based on their credit risk.[259] A 1996 industry sponsored poll of fifty of the then-most active subprime lenders came to a similar conclusion.[260] Accordingly, even if HOSA eliminates a majority of high cost loans in New Jersey, legitimate

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[253] *See* text accompanying *supra* notes __ to __.

[254] Studies considering the effects of HOEPA estimate that lowering the trigger two points from ten to eight percent will cover an increase of only 5% or 3% of loans. HUD-Treasury Report, *supra* note __ at 66.

[255] *See* Baher Azmy and David J. Reiss, *Squaring the Predatory Lending Circle*, (unpublished manuscript on file with the authors) at __.

[256] See WEICHER, *supra* note ___ at 34-35 (describing the substantial variety of underwriting criteria among subprime lending entities and within individual firms over time, which can result in large discrepancies in pricing to similarly-situated borrowers).

[257] *See* Mansfield, *supra* note __ at 536. In contrast, prime loans around that period fell into a range of under two percent. *Id.*

[258] Mansfield, *supra* note __ at 540 ("it is not clear that pricing in the subprime market has any basis at all…. Lenders will not calibrate price to risk when they can just as easily charge whatever rate they choose."). One study estimated that charging interest rates higher than justified by a borrower's credit risk costs American borrowers $2.9 billion annually. COST OF PREDATORY LENDING, *supra* note __ at 9-10.

[259] Freddie Mac Special Report on Automated Underwriting, September 1996, at http://www.freddiemac.com/corporate/reports/mosely/chap5.htm.

[260] *Inside B&C Lending*, June 10, 1996 at __

subprime lenders and even prime lenders will find a large, profitable range in which they would be willing to extend credit to traditional subprime borrowers. Indeed, the above-analysis suggests that pricing of subprime lending is sometimes so highly uncorrelated to credit risk and biased upward, that HOSA APR triggers could be set even lower without jeopardizing the provision of subprime credit in New Jersey.[261]

Second, the experience of other states that have enacted similar high cost loan regulations demonstrates that HOSA's attempts to diminish abusive lending practices will not also deplete legitimate subprime lending. In 1999, North Carolina became the first state to enact a comprehensive law to address predatory lending abuses in the residential mortgage market.[262] The North Carolina law is substantially similar to New Jersey's, by prohibiting loan terms and practices in connection with high cost loans – which North Carolina defined at ten percent higher than comparable Treasury rate and points and fees in excess of five percent of the total loan amount.[263] The North Carolina act prohibits, among many other things, financing of any points or fees, balloon payments, negative amortizations, loan flipping without reasonable, tangible net benefit to the borrower, prepayment penalties, and lending without regard to the borrower's ability to repay.[264]

Recent studies undertaken to evaluate the impact of the law on North Carolina's residential mortgage market demonstrates that the law operated almost exactly as intended.[265] These studies concluded that loan originations with predatory features decreased substantially in the state after the law's enactment,[266] but did not materially decrease either the supply of subprime credit to low income borrowers or the diversity of

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[261] *Cf.* Fed Reserve Board Commentary on Proposed Amendments to Regulation Z, 66 Fed. Reg. 65604 (Dec. 20, 2001) ("Data submitted by a trade association representing nondepository institution lenders suggest that there is an active market for HOEPA loans under the current APR trigger. There is no evidence that the impact on credit availability will be significant if the trigger is lowered").

[262] N.C. GEN. STAT. § 24-1.1A

[263] N.C. GEN. STAT. § 24-1.1A (6)(b)

[264] N.C. Gen. Stat. § 24-1.1A(7)(c)(2)

[265] *See* ROBERTO G. QUERCIA ET AL., CENTER FOR COMMUNITY CAPITALISM, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL, THE IMPACT OF NORTH CAROLINA'S ANTI-PREDATORY LENDING LAW: A DESCRIPTIVE ASSESSMENT, June 25, 2003; KEITH ERNST, ET AL., CENTER FOR RESPONSIBLE LENDING, NORTH CAROLINA'S SUBPRIME HOME LOAN MARKET AFTER PREDATORY LENDING REFORM, August 13, 2002.

[266] See QUERCIA, *supra* note __ at 18-20 and tbls. 11-13 (documenting North Carolina's comparative decrease in loans containing prepayment penalties, balloon payments and exceedingly high loan-to-value ratios); ERNST, *supra* note __ at 8-9 (documenting post-enactment decrease in flipped loans without reasonable, tangible net benefit to the borrower of 7%, decrease in "excess fees" of 25%, decrease in single premium credit insurance of 20%, decrease in incidence of loans with prepayment penalties of 35%, and estimating that law saved North Carolina homeowners a total of $100 million).

subprime mortgage products traditionally extended to them.[267] The results of the North Carolina studies suggest that subprime borrowers in New Jersey will enjoy the predicted benefits of HOSA – a significant decrease in the number of high cost loans with predatory terms – at the same time the subprime lending in New Jersey will still meet the needs of New Jersey's low-income borrowers.

B. The Negative (Over)Reaction Of The Secondary Market To HOSA

As previously described, lenders frequently pool together many of their mortgages, and through structured finance transactions organized by investment banks, securitize the mortgages and sell them to a variety of investors on the secondary market. [268] This process of securitization has in large part driven the dramatic rise of subprime lending in the past decade. [269] Prior to their sale, the secondary market demands that such transactions be rated by one or more of the major bond and securities rating agencies – Standard & Poor's Ratings Services ("S&P"), Fitch, Inc. ("Fitch") and Moody's Investors Service, Inc. ("Moody's") – to identify the level of risk associated with the pool. [270] The role of such agencies is essential to the operation of the entire subprime mortgage pipeline; indeed, without such a rating from at least one of these agencies, most investors on the secondary market will not buy into a mortgage pool.[271]

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[267] See QUERCIA, *supra* note ___ at 12-21 (concluding that subprime lending market in North Carolina still large and vibrant after law's enactment, that substantial portion of the limited decrease in subprime lending is attributable to decrease in predatory loans, and that subprime purchase loans actually increased after law's passage); ERNST, *supra* note __ at 3-7 (concluding that subprime market in North Carolina still very strong after act's passage, that proportion of subprime lending to lowest-income borrowers actually increased, and that there has been no increase in the pricing in subprime loans that might have been associated with a decrease in loan availability). *See also* KEITH D. HARVEY AND PETER J. NEGRO, DO PREDATORY LENDING LAWS INFLUENCE MORTGAGE LENDING? AN ANALYSIS OF THE NORTH CAROLINA PREDATORY LENDING LAW, September 2002 (attributing limited decline of subprime lending in North Carolina to decrease in loan application rates, not loan denial rates); *Inside B&C Lending*, March 5, 2001 (reporting that North Carolina lenders offering full range of mortgage products after law's enactment and that there was "little or no variation" in the pricing of those products as compared with other, neighboring states).

[268] *See* text accompanying *infra* notes __ to __.

[269] *See* text accompanying *infra* notes __ to __.

[270] *See* Standard and Poor's, *Evaluating Predatory Lending Laws: Standard and Poor's Explains its Approach*, April 15, 2003, at: http://www.housing choice.org/news%20stories/04152003.htm; Moody's Investor Services, Inc., *Moody's Reports on Impact of Predatory Lending Laws in RMBS*, March 26, 2003, at http://www.moodys.com; *see also* KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES § 1.18

[271] KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES § 1.18; s*ee also* Jonathan Fuerbringer, *Agencies to Continue to Rate Pools of New York Mortgages*, N.Y. TIMES at C4 (Mar. 1, 2003).

Recently, after Georgia passed a predatory lending law that contained a broad assignee liability provision applicable to those loans designated under that statute as high cost, the major rating agencies actually refused to rate residential mortgage-backed securities pools containing *any* loans that originated in Georgia after the effective date of the law. [272] The Georgia law authorized the borrower to assert against the assignee of a high cost home loan any and all claims the borrower could have asserted against a creditor but, unlike HOSA, failed to precisely define the differences among the various categories of regulated loans and provided no safe harbor protection for assignees who inadvertently purchased Georgia high cost loans despite having reasonable procedures in place to prevent such purchases. [273]

The rating agencies concluded that Georgia's assignee liability provisions created potentially unlimited damages for purchasers of high cost loans and were thus so risky that they could not be rated.[274] The agencies' announcement caused turmoil among Georgia lenders and signaled the imminent abandonment of financing for residential lending in the state. [275] Soon after, the Georgia legislature amended the statute in an attempt to address the rating agency concerns; specifically, the amended law clarified the distinction between high cost and other loans

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272 *See* Standard and Poor's Press Release, *Standard and Poor's to Disallow Georgia Fair Lending Act Loans*, Jan. 16, 2003, available at: http//www.mbaa.org/industry/news/03/016b.pdf; Moody's Investor Services Press Release, *Moodys Expands Consideration of Assignee Liability for Residential Mortgages in Securitizations*, Jan. 30, 2003, available at: http//www.mbaa.org/industry/news/03/0130a.pdf; Fitch Ratings Press Release, *Fitch Ratins Declines to Rate Georgia Loans in RMBS Pools, Considers Impact to Other Predatory Lending Legislation;* Feb. 5, 2003, http//www.mbaa.org/industry/news/0205b.html. The credit analysis performed by the rating agencies determine if any of the underlying loans covered by a predatory lending statute may be included in its rating transactions and what, if any, additional credit enhancements may be required. In performing an analysis of structured transactions backed by residential mortgage loans, rating agencies evaluate the impact a predatory lending law might have on the availability of funds to pay investors in the rated securities. *Id.*

273 *See* O.C.G.A. §7-6A-1, *et seq.*; Standard and Poor's, *Evaluating Predatory Lending Laws: Standard and Poor's Explains its Approach*, 03-4, April 15, 2003.

274 *See* Standard and Poor's Press Release, *Standard and Poor's to Disallow Georgia Fair Lending Act Loans*, Jan. 16, 2003, available at: http//www.mbaa.org/industry/news/03/016b.pdf; Moody's Investor Services Press Release, *Moodys Expands Consideration of Assignee Liability for Residential Mortgages in Securitizations*, Jan. 30, 2003, available at: http//www.mbaa.org/industry/news/03/0130a.pdf; Fitch Ratings Press Release, *Fitch Ratins Declines to Rate Georgia Loans in RMBS Pools, Considers Impact to Other Predatory Lending Legislation;* Feb. 5, 2003, http//www.mbaa.org/industry/news/0205b.html. *See also* Jonathan Fuerbringer, *Lending Law in New York Gets Different Interpretations*, N.Y. Times at C3 (Mar. 26, 2003).

275 *See* Georgia Banker's Ass'n, *GAFLA*: *The Unintended Consequences*, January 2003, available at http://www.gabankers.com/issuespredatorylending whitepaper.pdf

and included a safe harbor provision to protect assignees that inadvertently purchase high cost loans.[276] As a result, the agencies changed course and announced they would rate Georgia residential mortgages.[277]

Similarly, after the enactment of HOSA, S&P announced that it would not rate pools that contain certain New Jersey residential loans. Specifically, it announced that it would not rate pools that contain the following types of loans ("Excluded Loans"): High-Cost Home Loans; Covered Home Loans; Home Loans made in connection with home improvements ("Home Improvement Loans"); Home Loans made in connection with manufactured homes ("Manufactured Housing Loans"); and open- and closed-end cash-out refinancing or junior lien mortgage loans.[278] Purchase money mortgages, on the other hand, will be rated.[279]

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[276] Standard and Poor's, *Evaluating Predatory Lending Laws: Standard and Poor's Explains its Approach*, ~~3~~ 4, April 15, 2003.

[277] S&P announced that it would rate all pools that do not contain high cost loans. *See* Standard and Poor's, *Evaluating Predatory Lending Laws: Standard and Poor's Explains its Approach*, ~~3~~ 4, April 15, 2003. Fitch announced that it would rate all residential mortgage pools, including those that contained high cost loans, if they also included additional credit enhancements. *See* Press Release, *Fitch Revises its Rating Criteria in the Wake of Predatory Lending Legislation*, May 1, 2003, available at: www.fitchratings.com.

[278] S&P has excluded cash-out refinancings and junior lien loans "because the funds from these loans could be used for the purpose of home improvement (which loans carry the potential for assignee liability) and this fact may not be disclosed on origination." Standard & Poor's Addresses New Jersey Predatory Lending Law, Standard & Poor's at 3 (May 2, 2003) available at http://www.mbaa.org/industry/reports/03/sp_0502.pdf.

DOBI has taken the position that cash-out and junior lien mortgage loans are not subject to liability under Section 6(b) or 6(c) of the Act "unless a home improvement contractor or manufactured home seller made the loan or was otherwise involved as specified" in Section 6(a). DOBI, "lenders should look at a range of factors related to an individual borrower's circumstances." State of New Jersey Dep't of Banking and Insurance Bulletin No. 03-15, July 25, 2003, at 4. DOBI argues that the scope of Section 6(a) liability is based upon that imposed by the Federal Trade Commission's Holder in Due Course Rule. The FDC rule requires some degree of involvement by the home improvement contractor or manufactured home seller to become applicable to the transaction. Bureau of Consumer Protection, Federal Trade Commission, Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses 11,396-11,401 (CCH Consumer Credit Guide) (1976); *See* 16 C.F.R. § 433.2. The scope of Section 6 and that of the FTC rule do, indeed, overlap. And DOBI's interpretation of Section 6(a) is the most compelling. Nonetheless, it will be left up to the courts to decide whether the Legislature intended that that section be interpreted similarly to the FTC rule.

DOBI further notes that a lender will know whether a loan is a home improvement loan or manufactured home loan because the FTC rule requires that such a loan contains a prominent provision on the note itself that identifies it as a loan to which some assignee liability may be attached. The provision reads as follows:

NOTICE

S&P claims that several of the Act's damages provisions are unclear and, therefore may expose assignees to unlimited liability. S&P's position is problematic because it is motivating the lending industry in New Jersey to lobby for a significant dilution of HOSA's assignee liability provisions.[280] However, many of S&P's concerns appear overstated. For example, S&P states, without clear explanation, that the Act creates unlimited liability for assignees of Covered Home Loans.[281] However, as previously explained, assignee liability for Covered Home Loans is specifically limited by the Act to: (i) suits brought in an individual capacity; (ii) within six years; and (iii) for damages that cannot exceed the borrower's remaining obligation under the loan plus costs and reasonable attorneys fees.[282] Moreover, S&P's refusal to rate Home Improvement Loans and Manufactured Housing Loans is inconsistent with its current practice. As described, the FTC has long ago abrogated the application of the holder-in-due course rule to such loans and ever since S&P and other rating agencies have continuously rated them. HOSA's assignee liability provisions add nothing to that which previously existed without evident concern to S&P.

In any event, another of the rating agencies, Fitch, has concluded that, despite some arguable ambiguities in the Act's damages provisions, the risks to assignees are nevertheless low enough that it will continue to rate New Jersey mortgage pools that do not contain High Cost Home Loans. In other words, Fitch will, unlike S&P, rate pools that contain Home Loans, Covered Home Loans; Home Improvement Loans; and Manufactured Housing Loans, but only so long as Fitch receives

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> ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

16 C.F.R. § 433.2. This requirement, of course, would not protect the assignee who purchases from an originator who fails to comply with the FTC rule.

[279] Standard & Poor's, *Standard & Poor's Addresses New Jersey Predatory Lending Law* at 2 (May 2, 2003) available at http://www.mbaa.org/industry/reports/03/sp_0502.pdf.

[280] *S&P Surprises Lenders; Decision not to rate certain pools cuts new predatory law support*, Broker, June/July 2003 at 30 (quoting statement of HOSA supporter E. Robert Levy, executive director of the Mortgage Bankers Association of New Jersey/League of Mortgage Lenders, that "[w]e obviously are not going to be able to live with the bill in the present form, unless S&P changes their position).

[281] Standard & Poor's, *Standard & Poor's Addresses New Jersey Predatory Lending Law* at 2 (May 2, 2003) available at http://www.mbaa.org/industry/reports/03/sp_0502.pdf.

[282] *See* text accompanying *infra* notes __ to __.

certification by independent third parties that such pools do not contain any High Cost Home Loans.[283] Notwithstanding S&P's position, Fitch's decision to rate all but High Cost Home Loans should provide sufficient assurance for the secondary market to continue to finance such loans in New Jersey.

It is not surprising that both Fitch and S&P have refused to rate mortgage pools containing High Cost Home Loans. The expected consequence of this refusal is that the secondary market will cease almost entirely to finance and thereby will dry up the provision of High Cost Home Loans in New Jersey. This effectively renders the assignee liability provisions the most powerful in the entire Act. Because, as previously described, a substantial proportion of borrowers that have been stuck with High Cost Home Loans could have qualified for better mortgage terms, the evaporation of High Cost Home Loans will not significantly reduce the availability of credit for subprime borrowers. Indeed, such borrowers will likely be offered credit at a lower cost and with fairer terms.

CONCLUSION

In the past decade, predatory lending has become one of the most significant threats to the realization of the American dream of home ownership for low and moderate-income and African American persons. Indeed, one of the primary reasons predatory lending has been so elusive and devastating is that it has been difficult to define or regulate. Building upon the legislative efforts of the federal government and a small number of other states, the New Jersey Home Ownership Security Act implements an effective, balanced response that respects the complicated dynamic of the subprime residential mortgage market. Despite some minor ambiguities, the Act should accomplish much of its goal of curbing the worst abuses of predatory lending while preserving the availability of credit to all New Jersey consumers who need it.

[283] Fitch Ratings, *Fitch Ratings Responds to New Jersey Predatory Lending Legislation*, at 2 (June 5, 2003).